

(25,851)

20792
SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1916.

No. 1021.

SOUTHERN PACIFIC COMPANY, PLAINTIFF IN ERROR,

vs.

JOHN Z. LOWE, JR., UNITED STATES COLLECTOR OF
INTERNAL REVENUE FOR THE SECOND DISTRICT OF
NEW YORK.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR
THE SOUTHERN DISTRICT OF NEW YORK.

25
INDEX.

	Page
Citation and service.....	c1
Writ of error.....	c1
Amended complaint	c2
Answer to amended complaint.....	c13
Minute entries of proceedings.....	c17
Stipulation as to trial of case, &c.....	c17
Order amending title, &c.....	c18
Opinion, Manton, J.....	c18
Judgment	c23
Bill of exceptions.....	1
Colloquy between court and counsel, &c.....	1
Stipulation of facts.....	5

	Page
Testimony of Frederick Van Note.....	6
G. L. King.....	12
T. O. Edwards.....	22
John P. Duffy.....	37
E. T. Johnson.....	42
C. P. Lincoln.....	50
George T. Holbrook.....	81
Robert Adams.....	96
Mr. King.....	105
Mr. Lincoln (recalled).....	106
Angus D. McDonald.....	113
Thomas H. McDannel.....	130
Plaintiff's Exhibit 2a—Income tax return, form No. 1032, of South- ern Pacific Company.....	139
2b—Letter, Osborn to Southern Pacific Co., May 15, 1915.....	142
2c—Brief (not set out).....	143
2d—Letter, Lowe to Southern Pacific Co., August 4, 1915.....	144
2e—Claim for taxes improperly collected, &c....	145
2f—Letter (not set out).....	147
2g—Stipulation (not set out).....	147
2h—Statement of dividends received during six months ending June 30, 1914.....	148
2i—Stipulation as to testimony and exhibits....	149
2j—Accounting regulations (not set out).....	149
Plaintiff's Exhibits A and B—Resolutions adopted by board of di- rectors December 29, 1913.....	150
Plaintiff's Exhibit C—Resolution of December 23, 1913.....	151
D—Resolution adopted by board of directors June 13, 1914.....	152
E—Amendment to lease between Central Pacific Railroad Co. and Southern Pacific Co., &c....	152
F—List of stockholders of Central Pacific Co....	163
G—Statement of income, Central Pacific Railway Co., June 30, 1910, to June 30, 1914, &c....	164
H—Statement.....	167
I—Statement.....	173
J—Statement showing debits and credits to profit and loss during years ended June 30, 1910, to June 30, 1914, Central Pacific Railway Co.	173
K—Statement of income and profit and loss of Central Pacific Railway Co., &c., 1913.....	175
L—Statement of income and profit and loss of Central Pacific Railway Co., &c., 1914.....	177
M—(Not set out).....	179
N—Statement of income for fiscal years ended June 30, 1910, to June 30, 1914, &c.....	180
O—Letter, Osborn to Central Pacific Railway Co., February 11, 1914.....	183

INDEX.

iii

Page

P—Income tax return of Central Pacific Railway Co., December 31, 1913.....	186
Q—Statement of income for fiscal years ended June 30, 1910, to June 30, 1914, &c.....	190
R—Statement showing profit and loss upon which income tax was paid, &c., 1910 to 1914, Central Pacific Railway Co.....	192
S—Statement showing excess of dividends paid over taxable net income, 1910 to 1914, &c., Central Pacific Railway Co.....	193
T—Summary showing excess of dividends over taxable income, &c., 1910 to 1914, Central Pacific Railway Co.....	196
U—Articles of association of Central Pacific Railway Co. (not set out).....	197
Order filing bill of exceptions.....	198
Consent to bill of exceptions.....	198
Petition for writ of error.....	199
Assignment of errors.....	199
Bond on writ of error.....	204
Order allowing writ of error.....	208
Stipulation as to record.....	208
Clerk's certificate	200



THE UNITED STATES OF AMERICA, ss:

To John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, Greeting:

You are hereby cited and admonished to be and appear at a Supreme Court of the United States, to be holden at the City of Washington on the 13th day of April next pursuant to a Writ of Error filed in the Clerk's Office of the District Court of the United States for the Southern District of New York, wherein Southern Pacific Company is plaintiff and you are defendant in error, to show cause, if any there be, why the judgment rendered against the said plaintiff in error as in the said Writ of Error mentioned should not be corrected, and speedy justice be done to the parties in that behalf.

Given under my hand in the Borough of Manhattan, City of New York, in the said District, this 15th day of March in the year of our Lord one thousand, nine hundred and seventeen.

MARTIN T. MANTON,
*Judge of the District Court of the United States
for the Southern District of New York.*

A copy of the within paper has been this day received at this office. Mar. 15, 1917. H. Snowden Marshall, U. S. Attorney. Edgar.

[Endorsed:] L. 14-300. Citation. U. S. District Court, S. D. of N. Y. Filed Mar. 15, 1917. 110/K.

THE UNITED STATES OF AMERICA, ss:

The President of the United States of America to the Judges of the District Court of the United States for the Southern District of New York, Greeting:

Because in the record and proceedings, and also in the rendition of the judgment of a plea which is in the said District Court, before you, between Southern Pacific Company, plaintiff, and John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, defendant, a manifest error has happened, to the great damage of the said Southern Pacific Company, as by its complaint appears. We being willing that the error, if any has been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the Supreme Court of the United States, together with this Writ, so that you may have the same at the City of Washington on the 13th day of April, 1917, in the said Supreme Court, to be then and there held, that the record and proceedings aforesaid being inspected, the said Supreme Court may cause further to be done

to correct that error, what of right, and according to the laws and customs of the United States, should be done.

Witness, the honorable Edward D. White, Chief Justice of the United States, this 15th day of March in the year of our Lord one thousand, nine hundred and seventeen, and of the Independence of the United States the one hundred and forty-first.

[Seal District Court of the United States, Southern District of N. Y.]

ALEX. GILCHRIST, JR.,
*Clerk of the District Court of the United States
for the Southern District of New York.*

Allowed:

MARTIN T. MANTON,
United States District Judge.

[Endorsed:] L. 14-300. Supreme Court of the United States Southern Pacific Company, Plaintiff in Error, against John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, Defendant in Error. Writ of Error. Gordon M. Buck, Attorney for Plaintiff in Error, No. 165 Broadway, Borough of Manhattan, City of New York. U. S. District Court, S. D. of N. Y. Filed Mar. 15, 1917. 110/K.

Received a true copy of the within Writ of Error for Defendant in Error this — day of —, 1917.

*Clerk of the District Court of the United States
for the Southern District of New York.*

United States District Court for the Southern District of New York.

L-14-300.

SOUTHERN PACIFIC COMPANY, Plaintiff,

v.

JOHN Z. LOWE, JR., as United States Collector of Internal Revenue for the Second District of New York, Defendant.

Amended Complaint.

Southern Pacific Company, the plaintiff above named, complaining of the defendant, by Gordon M. Buck, its attorney, alleges as follows, on information and belief:

For a First Cause of Action.

First. Southern Pacific Company, the plaintiff above named, is a corporation duly organized and existing under and by virtue of the laws of the State of Kentucky, and is a resident of said State.

Second. John Z. Lowe, Jr., the defendant above named, was on or about the first day of April, 1915, duly appointed, and thereupon duly qualified and was duly commissioned, Collector of Internal Revenue of the United States for the Second District of New York, and ever since has been and now is acting as such, and is a citizen and resident of the Southern District of New York.

Third. On or about the 30th day of March, 1914, the plaintiff, pursuant to the terms of the Act of Congress, entitled "An Act to reduce tariff duties and provide revenue for the Government and for other purposes," approved October 3, 1913 (hereinafter referred to as the "Income Tax Act"), filed with Charles W. Anderson, the then Collector of Internal Revenue for the Second District of New York, and the predecessor in office of the defendant, a return of its income for the year ending December 31, 1913. The said return showed a net income for tax purposes accruing during the said year, amounting to the sum of \$4,883,495.76. The said return stated that it excluded from the plaintiff's taxable income the sum of \$6,836,894.05, namely, seven-twelfths of the plaintiff's entire net income for the said year, being the portion of such income accruing from March 1, 1913, to October 3, 1913.

Thereafter and prior to May 21, 1914, the Commissioner of Internal Revenue of the United States, acting under and pursuant to the terms of the Income Tax Act, made an amended return on behalf of the plaintiff for the said year, and included in its net income which he claimed was taxable under the Income Tax Act the said sum of \$6,836,894.05, which the plaintiff had excluded therefrom, as aforesaid, and thereafter and prior to the 21st day of May, 1914, the said Commissioner assessed a tax thereon of \$68,368.94. The entire tax assessed by the said Commissioner against the plaintiff as aforesaid for the year ending December 31, 1913, amounted to the sum of \$117,203.90, which on or about the 26th day of June, 1914, was paid by the plaintiff to the said Charles W. Anderson, as Collector aforesaid.

Fourth. Thereafter and prior to the 4th day of August, 1915, the said Commissioner, purporting to act under and pursuant to the terms of the Income Tax Act, made a further amended return on behalf of this plaintiff for the year ending December 31, 1913, and included in its net income which he claimed was taxable under the Income Tax Act, items aggregating \$13,296,114.27. Among the items so included were the following, namely:

1. Dividends, both regular and extraordinary, paid by other corporations to the plaintiff during the calendar year 1913 from surplus accruing to such other corporations prior to January 1, 1913, as follows, viz.:

(a) Extraordinary dividend of more than 14%, paid April 9, 1913, by Central Pacific Railway Company on its preferred capital stock, in order to make the total dividend on such preferred stock for the years 1907 to 1912, both inclusive, average six per cent. per annum (the annual dividend on such stock during the said years having been paid at the rate of four per centum per annum)	\$2,460,000.
(b) Extraordinary dividend of 25% paid June 26, 1913, by the Kern Trading & Oil Company, for the purpose of distributing surplus earned from the organization of the Company in 1903 (except a working capital and the amount tied up in investments)	1,750,000.
(c) Liquidating dividend paid June 24, 1913, by the Clark Oil Company upon its dissolution (the stock on which this dividend was paid having cost the plaintiff \$17,762.24)	121,000.
(d) Extraordinary dividend of 63% paid October 7, 1913, by Huntington Land and Townsite Company on its capital stock	2,100.
(e) Dividend of 20% paid June 18, 1913, by the Houston and Shreveport Railroad Company on its capital stock	79,520.
(f) Dividend of 3% paid June 18, 1913, by Houston and Texas Central Railroad Company on its capital stock	200,952.
(g) Dividend of 10% paid June 27, 1913, by Louisiana Western Railroad Company on its capital stock ..	336,000.
(h) Extraordinary dividend of 33 1/3%, paid June 23, 1913, by the Albion Lumber Company upon its capital stock	100,000.
(i) Extraordinary dividend of 20%, paid June 23, 1913, by the Rifled Pipe Company upon its capital stock	31,000.00
(j) Dividend of 20% paid June 16, 1913, by Texas Town Lot Company on its capital stock	3,940.00

(k) Dividend of 50% paid in April, 1913, by Reward Oil Company on its capital stock	22,222.22	
		\$5,205,734.22

2. So much of the following regular periodical dividends received by the plaintiff from other corporations as were apportionable to that part of the period for which they were declared elapsing prior to January 1, 1913, viz:

(a) Semi-annual dividend of 2% paid in February, 1913, by Central Pacific Railway Company on its preferred capital stock, two-thirds of such dividend being excluded as applying to period prior to January 1, 1913	\$232,000.00
(b) Annual dividend of 2% paid in June, 1913, by Central Pacific Railway Company on its preferred capital stock (this dividend being intended to adjust the dividends of 2% each, paid respectively in August, 1912, and February, 1913, so that dividends for year ending February 28, 1913, on preferred stock would equal 6%), five-sixths of such dividend being excluded as applying to period prior to January 1, 1913.....	290,000.00
(c) Annual dividend of 6% paid in June, 1913, by Central Pacific Railway Company on its common capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913.....	2,018,285.00
(d) Annual dividend of 6% paid in June, 1913, by Southern Pacific Railroad Company on its capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913.....	4,800,000.00
(e) Annual dividend of 4% paid in June, 1913, by Houston, East & West Texas Railway Company on its capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913	38,382.00

(f) Annual dividend of 6% paid in June, 1913, by Southern Pacific Terminal Company on its capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913.....	59,988.00
(g) Semi-annual dividend of 1½% paid in April, 1913 by Associated Oil Company on its common capital stock, one-third of such dividend being excluded as applying to period prior to January 1, 1913.....	100,345.00
(h) Annual dividend of 10% paid in June, 1913, by Pacific Fruit Express Company on its capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913.....	270,000.00
(i) Annual dividend of 3% paid in June, 1913, by Rio Bravo Oil Company on its capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913.....	127,410.00
(j) Annual dividend of 2¼% paid in June, 1913, by San Bernardino & Redlands R. R. Co. on its capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913.....	2,250.00
(k) Annual dividend of six per cent. paid in June, 1913, by Southern Pacific Building Company on its capital stock, one-half of such dividend being excluded as applying to period prior to January 1, 1913.....	11,985.00
(l) Quarterly dividend of 5% paid in January, 1913, by United States Rail Company on its capital stock, two-thirds of such dividend being excluded as applying to period prior to January 1, 1913.....	21.17
	<hr/>
	\$7,950,648.17
	<hr/>
	\$13,156,380.89

The plaintiff had excluded the said sum of \$13,156,380.89 from the said return of its income for the reason that the said sum constituted capital and not income, since it had arisen and accrued to the plaintiff prior to January 1, 1913, and prior to the adoption of the Sixteenth Amendment to the Constitution of the United States.

and any attempt to assess a tax thereon, without apportionment among the several states according to numbers, would constitute the levy of a direct tax in violation of the third clause of Section Two of Article I of the Constitution of the United States and of the fourth clause of Section Nine of said Article I, and would constitute an unequal and discriminatory burden in violation of the plaintiff's rights under the Constitution of the United States, and that the Income Tax Law did not by its terms impose a tax on the said sum and if construed as imposing a tax thereon was unconstitutional and void. The said return filed by the plaintiff stated that items of said character had been excluded therefrom.

Thereafter and prior to the said 4th day of August, 1915, the said Commissioner, purporting to act under and pursuant to the terms of the Income Tax Act, assessed an alleged tax against the plaintiff upon the said sum of \$13,156,380.39, which had been included by the said Commissioner in the amended return prepared by him. The alleged tax so assessed amounted to the sum of \$131,563.80. The entire alleged tax assessed by the said Commissioner against the plaintiff in accordance with the amended return prepared by him as hereinbefore in this paragraph numbered Fourth set forth, including the said sum of \$131,563.80, amounted to the sum of \$132,961.14.

All of the stock upon which dividends had been paid to the plaintiff as hereinbefore in this paragraph Fourth set forth has been acquired by the plaintiff prior to January 1, 1913.

Fifth. On or about the said 4th day of August, 1915, the defendant, purporting to act under and pursuant to the terms of the Income Tax Act, notified the plaintiff of the said assessment and demanded the payment of the said sum of \$132,961.14. Thereafter, and on or about the 13th day of August, 1915, this plaintiff, in order to avoid the threatened collection of said tax with interest and penalties, paid to the defendant the said sum of \$132,961.14, which included the said alleged tax of \$131,563.80 hereinbefore referred to. The said payment was made under protest and for the purpose solely of avoiding penalties and controversy and litigation, and without prejudice to the plaintiff's right thereafter to demand repayment of the whole or any part of the said alleged tax so illegally assessed and collected, or otherwise to contest the constitutionality of any or all provisions of the Income Tax Act or the constitutionality or legality of any or all regulations or rulings of the United States Treasury Department relating thereto. The said protest was in writing and stated the purpose for which said payment was made, as aforesaid, and set forth that the plaintiff could not constitutionally or lawfully be required to make said payment or to perform any of the acts required under Paragraph G of Section II, or under Paragraph 8 of Section IV of the Income Tax Act, or under any other provision of said Sections II and IV, or any part thereof; that such sections of said Act, and the regulations of the United States Treasury Department purporting to have been made pursuant thereto, imposed unjust and unequal and discriminatory burdens upon the plaintiff in violation of its rights under the Constitution of the United States,

and were therefore unconstitutional and void; that said regulations, both in respect to the tax under said Paragraph G and otherwise, were unauthorized and illegal, and that said alleged tax and all thereof had been illegally and erroneously assessed; that said alleged tax had been imposed upon income received prior to October 3, 1913, and therefore was a tax on capital and a direct tax, and illegal and unconstitutional because not laid in proportion to population; that the said Act should not be construed as imposing an income tax on income accruing prior to October 3, 1913, or on dividends (either extraordinary or periodical) received by the plaintiff from other corporations and paid by the latter from surplus earned prior to the said date, nor as applicable either (a) to dissolution dividends, or (b) to such portion of a regular periodical dividend paid for a period partly before and partly after the adoption of said Act as was applicable to that portion of such period as had elapsed prior to the adoption of the said Act. The said payment was not made as aforesaid until it had been demanded by the defendant and until this plaintiff had been notified by him that if not paid within ten days, it would become his duty, under the Income Tax Act, to collect the said alleged tax, together with five per centum additional and interest at one per centum per month until paid.

Sixth. The plaintiff owns the entire capital stock of the said Central Pacific Railway Company. The plaintiff and the railroad companies hereinbefore mentioned and other transportation corporations controlled by the plaintiff through stock ownership form a unified transportation system. The earnings of the various companies constituting the system are kept together. The earnings of the subsidiary companies are deposited in the plaintiff's bank accounts, and, on the other hand, if the subsidiary corporations need money for additions or betterments or to make up a deficit from operations, the necessary funds are advanced to them by the plaintiff. Proper entries on the books of the various companies in interest are kept, but, as a practical matter, no distinction is made as to the ownership of such funds.

In July, 1915, and prior to the assessment of the alleged tax mentioned in paragraph numbered Fourth hereof, an argument was made by the plaintiff before the Commissioner of Internal Revenue in opposition to such alleged tax, and the facts hereinbefore stated in this paragraph Sixth were brought to the attention of the said Commissioner.

Seventh. Thereafter and on or about the 13th day of August, 1915, the plaintiff duly appealed to said Commissioner from his assessment of the said alleged tax hereinbefore referred to, and upon the grounds set forth in paragraphs numbered Fourth and Eighth hereof duly requested a refund of the said sum of \$131,563.80 so erroneously and illegally assessed and collected; and on or about the 15th day of October, 1915, the said appeal was denied.

Eighth. The said sum of \$131,563.80 paid by the plaintiff as hereinbefore set forth, was unlawfully and illegally assessed and collected as aforesaid, and there existed no warrant in law for the pretended assessment of the said alleged tax against the plaintiff.

The said alleged tax was in each case assessed upon income which had arisen and accrued to the plaintiff prior to January 1, 1913, and prior to the adoption of the Sixteenth Amendment to the Constitution of the United States, and which had then become capital and was not income subject to tax under the terms of the Income Tax Act; and the Income Tax Act, if and so far as it is construed as imposing a tax thereon, is unconstitutional and void for the reason that it seeks to levy a direct tax, in violation of the third clause of Section Two of Article I of the Constitution of the United States and of the fourth clause of Section Nine of said Article I, and for the further reason that it imposes unjust and unequal and discriminatory burdens on the plaintiff in violation of the Fifth Amendment to the Constitution of the United States.

Ninth. No part of the said sum paid by this plaintiff to the defendant has been repaid to the plaintiff (except that the plaintiff has been credited with the sum of \$177.62 upon the assessment purporting to have been made against it for the six months ending June 30, 1914). The defendant paid the said sum of \$131,563.80 into the Treasury of the United States; and the alleged tax having been erroneously and illegally assessed against this plaintiff and the amount thereof paid by it under protest and duress, and being wrongfully and illegally retained from the plaintiff, it is the duty of the defendant to repay the amount thereof to this plaintiff, together with interest hereon at the rate of six per centum per annum from the said 13th day of August, 1915, until repaid.

For a Second Cause of Action.

Tenth. The plaintiff repeats and re-alleges all of the allegations contained in paragraphs numbered First and Second of this complaint.

Eleventh. On or about the 28th day of September, 1914, the plaintiff, pursuant to the terms of the Act of Congress entitled "An Act to reduce tariff duties and provide revenue for the Government and for other purposes," approved October 3, 1913 (hereinafter referred to as the "Income Tax Act"), filed with the defendant a return of its income for the six months ending June 30, 1914, showing a net income for tax purposes of \$19,310,153.72. Thereafter, the Commissioner of Internal Revenue of the United States, acting under and pursuant to the terms of the Income Tax Act, made an amended return on behalf of the plaintiff for the said six months, including therein \$1,000,000 of income which had been excluded by the plaintiff, and thereafter the said Commissioner assessed a tax against the plaintiff amounting to the sum of \$203,101.54, which was paid by the plaintiff to the defendant on or about June 29, 1915.

Twelfth. Thereafter the said Commissioner of Internal Revenue of the United States, purporting to act as aforesaid, made a further amended return on behalf of this plaintiff for the said six months, and included in its net income, which he claimed was taxable under the Income Tax Act, additional items aggregating \$19,239,580.92. Among the items so included were dividends, both regular and extra-

ordinary, paid by other corporations to the plaintiff during the six months ending June 30, 1914, from surplus accruing to such other corporations prior to January 1, 1913, as follows, viz :

1. Extraordinary dividend of 20% paid January 10, 1914, by Central Pacific Railway Company on its preferred capital stock.....	\$3,480,000.00
2. Extraordinary dividend of 20% paid January 10, 1914, by Central Pacific Railway Company on its common capital stock.....	13,455,100.00
3. Extraordinary dividend paid January 2, 1914, by Central Pacific Railway Company, distributing pro rata on its preferred and common capital stock the proceeds of sale of land at Rockaway Beach, New York (this property having been acquired by the said Railway Company in the year 1901 and sold in December, 1913).....	514,000.00
4. Extraordinary dividend of 60% paid June, 1914, by Reward Oil Company on its capital stock.....	26,866.64
5. Dividend of 6% paid June 13, 1914, by Central Pacific Railway Company on its common capital stock, such dividend amounting to \$4,036,530, and exceeding the net earnings of said Company since January 1, 1913, available for said dividend by	912,497.48
Total	\$18,388,264.12

The stock of the Central Pacific Railway Company and of the Reward Oil Company upon which dividends had been paid to the plaintiff as hereinbefore in this paragraph Twelfth set forth had been acquired by the plaintiff prior to January 1, 1913.

The plaintiff had excluded the said sum of \$18,388,264.12 from the said return of its income for the reason that the said sum constituted capital and not income, since it had arisen and accrued to the plaintiff prior to January 1, 1913, and prior to the adoption of the Sixteenth Amendment to the Constitution of the United States, and in the case of the said Central Pacific Railway Company, in large part consisted of the proceeds of the sale of lands granted to it by the United States to aid the said Central Pacific Railway Company in the construction of its railroads, and any attempt to assess a tax on the said sum without apportionment among the several states according to numbers, would constitute the levy of a direct tax, in violation of the third clause of Section Two of Article I of the Constitution of the United States, and of the fourth clause of Section Nine of said Article I; that the Income Tax Law did not by its terms impose a tax on the said sum and if construed as imposing a tax thereon was unconstitutional and void. The said return filed by the plaintiff as aforesaid stated that items of said character had been excluded therefrom.

Thereafter and prior to the 4th day of August, 1915, the said Com-

missioner, purporting to act under and pursuant to the terms of the Income Tax Act, assessed an alleged tax against the plaintiff upon the said sum of \$18,388,264.12. The alleged tax so assessed amounted to the sum of \$183,882.64. The entire alleged tax assessed by the said Commissioner against the plaintiff in accordance with the amended return prepared by him as hereinbefore in this paragraph numbered Twelfth set forth, including the said sum of \$183,882.64, amounted to the sum of \$192,218.19, which included a credit of \$177.62 referred to in paragraph numbered Ninth hereof.

Thirteenth. On or about the 4th day of August, 1915, the defendant, purporting to act under and pursuant to the Income Tax Act, notified the plaintiff of the said assessment, and demanded the payment of the said sum of \$192,218.19. Thereafter, and on or about the 13th day of August, 1915, the plaintiff, in order to avoid the threatened collection of said tax, with interest and penalties, paid to the defendant the said sum of \$192,218.19, which included the said alleged tax of \$183,882.64 hereinbefore referred to. The said payment was made under protest and for the purpose solely of avoiding penalties and controversy and litigation, and without prejudice to the plaintiff's right thereafter to demand repayment of the whole or any part of the said alleged tax so illegally assessed and collected, or otherwise to contest the constitutionality of any of the provisions of the Income Tax Act or the constitutionality or legality of any or all regulations or rulings of the United States Treasury Department relating thereto. The said protest was in writing and stated the purpose for which such payment was made, as aforesaid, and set forth that the plaintiff could not constitutionally or lawfully be required to make said payment or to perform any of the acts required under paragraph G of Section II of the Income Tax Act, or under any other provision of said Section II, or any part thereof; that the said section of said Act and the regulations of the United States Treasury Department purporting to have been made pursuant thereto imposed unjust and unequal and discriminatory burdens upon the plaintiff in violation of its rights under the Constitution of the United States, and were therefore unconstitutional and void; that said regulations, both in respect to the assessment of taxes under said Paragraph G, and otherwise, were unauthorized and illegal, and that said alleged tax and all thereof had been illegally and erroneously assessed; that said alleged tax had been imposed upon income accruing prior to October 3, 1913, and therefore was a tax on capital and a direct tax, and illegal and unconstitutional because not laid in proportion to population; that the said Act should not be construed as imposing a tax on dividends (either extraordinary or periodical) received by the plaintiff from other corporations and paid by the latter from surplus earned prior to October 3, 1913, nor as applicable to dividends paid from the proceeds of sales of lands granted to railroad companies in aid of the construction thereof, or to dividends derived from an increase in value of corporate property. The said payment was not made as aforesaid until it had been demanded by the defendant and until the plaintiff had been notified by him that, if not paid within ten days, it would become his duty, under the Income Tax Act, to collect the said alleged tax, together with five

per centum additional and interest at one per centum per month until paid.

Fourteenth. The plaintiff owns the entire capital stock of the said Central Pacific Railway Company. The plaintiff and the said Central Pacific Railway Company and other transportation corporations controlled by the plaintiff through stock ownership form a unified transportation system. The earnings of the various companies constituting the system are kept together. The earnings of the subsidiary companies are deposited in the plaintiff's bank accounts, and, on the other hand, if the subsidiary corporations need money for additions or betterments or to make up a deficit from operations, the necessary funds are advanced to them by the plaintiff. Proper entries on the books of the various companies in interest are kept, but, as a practical matter, no distinction is made as to the ownership of such funds.

In July, 1915, and prior to the assessment of the alleged tax mentioned in paragraph numbered Twelfth hereof, an argument was made by the plaintiff before the Commissioner of Internal Revenue in opposition to such alleged tax, and the facts hereinbefore stated in this paragraph Fourteenth were brought to the attention of the said Commissioner.

Fifteenth. Thereafter and on or about the 13th day of August, 1915, the plaintiff duly appealed to said Commissioner from his assessment of the said alleged tax hereinbefore referred to, and upon the grounds set forth in paragraphs numbered Twelfth and Sixteenth hereof, duly requested a refund of the said sum of \$183,882.64 so erroneously and illegally assessed and collected, and that on or about the 15th day of October, 1915, the said appeal was denied.

Sixteenth. The said sum of \$183,882.64 paid by the plaintiff, as hereinbefore set forth, was unlawfully and illegally assessed and collected, as aforesaid, and there existed no warrant in law for the pretended assessment of the said alleged tax against the plaintiff. The said alleged tax was assessed upon income which had arisen and accrued to the plaintiff prior to January 1, 1913, and prior to the adoption of the Sixteenth Amendment to the Constitution of the United States, and which had become capital and was not income subject to tax under the terms of the Income Tax Act; and the Income Tax Act, if and so far as it is construed as imposing a tax thereon is unconstitutional and void for the reason that it seeks to levy a direct tax in violation of the third clause of Section Two of Article I of the Constitution of the United States and of the fourth clause of Section Nine of said Article, and for the further reason that it imposes unjust and unequal and discriminatory burdens on the plaintiff in violation of the Fifth Amendment to the Constitution of the United States.

Seventeenth. No part of the said sum of \$183,882.64 paid by this plaintiff to the defendant under protest as aforesaid has been repaid to the plaintiff; but, the defendant paid the said sum into the Treasury of the United States, and the alleged tax having been erroneously and illegally assessed against this plaintiff and the amount thereof paid by it under protest and duress, and the said amount being wrongfully and illegally retained from the plaintiff,

it is the duty of the defendant to repay the amount thereof to this plaintiff, together with interest thereon at the rate of six per centum per annum from the 13th day of August, 1915, until repaid.

Wherefore, the plaintiff demands judgment against the defendant for the sum of three hundred fifteen thousand, two hundred sixty-eight and 82/100 Dollars (\$315,268.82), with interest thereon from August 13, 1915, at the rate of six per centum per annum, together with the costs of this action, and for such other and further relief as may be just.

GORDON M. BUCK,
Attorney for Plaintiff.

Office and Post Office Address, 165 Broadway, Borough of Manhattan, City of New York, N. Y.

STATE OF NEW YORK,
County of New York, ss:

Angus D. McDonald, being duly sworn, says: That he is a Vice-President and Controller of the Southern Pacific Company, the plaintiff above named; that he has read the foregoing amended complaint and knows the contents thereof, and that the same is true of his own knowledge, except as to the matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true; and that the reason why the complaint is not verified by the plaintiff is that the plaintiff is a foreign corporation.

A. D. McDONALD.

Subscribed and sworn to before me this 25th day of April, 1916.

[SEAL.]

CHARLES FRANKLIN,

Notary Public New York County No. 122.

Commission expires March 30, 1918.

[Endorsed:] United States District Court for the Southern District of New York. Southern Pacific Company, Plaintiff, v. John Z. Lowe, Jr., as United States Collector of Internal Revenue for the Second District of New York, Defendant. Amended Complaint. Gordon M. Buck, Attorney for Plaintiff, No. 165 Broadway, Borough of Manhattan, City of New York. A copy of the within paper has been this day received at this office. April 25, 1916. H. Snowden Marshall, U. S. Attorney. Filed Apr. 26, 1916. U. S. District Court, S. D. of N. Y.

United States District Court for the Southern District of New York.

L-14/300.

SOUTHERN PACIFIC COMPANY, Plaintiff,

v.

JOHN Z. LOWE, JR., as Collector of Internal Revenue, etc., Defendant.

Answer to Amended Complaint.

The defendant, by H. Snowden Marshall, United States Attorney for the Southern District of New York, his attorney, for his answer

to the amended complaint of the plaintiff herein, alleges as follows, on information and belief:

Answer to the First Cause of Action.

I. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the first paragraph of the complaint.

II. He admits the truth of the allegations contained in the second paragraph of the complaint.

III. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the third paragraph of the complaint, except that he admits (1) that on or about March 30, 1914, the plaintiff filed with Charles W. Anderson, the then Collector of Internal Revenue for the Second District of New York, what purported to be a return of its income for the year ending December 31, 1913, and he begs leave to refer to said return, a duly certified copy of which will be produced at the trial hereof, for the contents thereof; (2) that the Commissioner of Internal Revenue, pursuant to the terms of the Income Tax Act, amended the aforesaid return by including in plaintiff's net income the sum of \$6,836.894.05, and (3) that the said Commissioner on said return as so amended assessed against the plaintiff a tax of \$117,203.90; and (4) that on June 26, 1914, plaintiff paid to the said Charles W. Anderson the said tax of \$117,203.90.

IV. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the fourth paragraph of the complaint, except that he admits (1) that on July 30, 1915, the said Commissioner, pursuant to the terms of the Income Tax Act, further amended the aforesaid return by including in plaintiff's taxable net income the sum of \$13,296,114.27 received by it during the year ending December 31, 1913, and (2) that the said Commissioner thereupon assessed an additional tax against the plaintiff of \$132,961.14, which included the tax of \$131,563.80 referred to in the fourth paragraph of the complaint.

V. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the fifth paragraph of the complaint, except that he admits (1) that pursuant to the terms of the Income Tax Act he notified the plaintiff of the said assessment and demanded payment of the said tax of \$132,961.14, and (2) that on August 13, 1915, the plaintiff paid to him the said tax of \$132,961.14.

VI. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the sixth paragraph of the complaint.

VII. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the seventh paragraph of the complaint, except that he admits (1) that on August 13, 1915, plaintiff filed with him what purported to be a claim for the refund of the sum of \$201,330.08; and (2) that on October 15, 1915, the said Commissioner rejected said claim.

VIII. He denies the truth of the allegations contained in the eighth paragraph of the complaint.

IX. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the ninth paragraph of the complaint, except that he admits (1) that no part of the said sum paid by the plaintiff to him has been repaid to the plaintiff (except that the plaintiff has been credited with the sum of \$177.82 upon the assessment made against it for the six months ending June 30, 1914); and (2) that the said sum was covered into the Treasury of the United States.

Answer to the Second Cause of Action.

X. The defendant repeats and realleges all the allegations, admissions and denials contained in paragraphs numbered I and II of this answer.

XI. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the eleventh paragraph of the complaint, except that he admits (1) that on the 29th day of September, 1914, the plaintiff, pursuant to the terms of the Income Tax Act, filed with him what purported to be a return of its income for the six months ending June 30, 1914, and he begs leave to refer to said return, a duly certified copy of which will be produced at the trial heresof, for the contents thereof; and (2) that thereafter the Commissioner of Internal Revenue, pursuant to the terms of said Act, amended said return by including in plaintiff's net income the sum of \$1,000,000 of income which had been excluded by the plaintiff; and (3) that thereafter the said Commissioner assessed a tax against the plaintiff amounting to \$203,101.54, which was paid by plaintiff to the defendant on or about June 29, 1915.

XII. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the twelfth paragraph of the complaint, except that he admits (1) that pursuant to the said Act, the Commissioner of Internal Revenue further amended said return by including in plaintiff's gross income as shown by said return the sum of \$19,270,893.51; and by including the sum of \$49,074.83 in the deductions from said gross income, thereby increasing the amount of the net income by the sum of \$19,221,818.68; and (2) that the said Commissioner thereupon assessed an additional tax against the plaintiff of \$192,218.19, which included the said tax of \$183,882.64 referred to in the twelfth paragraph of the complaint.

XIII. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the thirteenth paragraph of the complaint, except that he admits (1) that pursuant to the terms of the Income Tax Act he notified the plaintiff of the said assessment and demanded payment of the said tax of \$192,218.19; and (2) that on August 13, 1915, the plaintiff paid to him the sum of \$192,218.19, which included the said tax of \$183,882.64.

XIV. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the fourteenth paragraph of the complaint.

XV. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the fifteenth

paragraph of the complaint, except that he admits (1) that on August 13, 1915, plaintiff filed with him what purported to be a claim for the refund of \$183,882.64; and (2) that on October 15, 1915, the said claim was rejected by said Commissioner.

XVI. He denies the truth of the allegations contained in the sixteenth paragraph of the complaint.

XVII. He denies any knowledge or information sufficient to form a belief as to the truth of the allegations contained in the seventeenth paragraph of the complaint, except that he admits (1) that no part of the said sum of \$183,882.64 has been repaid to the plaintiff by him; and (2) that said sum was by him covered into the Treasury of the United States.

Wherefore, defendant demands judgment dismissing the complaint of the plaintiff, together with the costs and disbursements of this action.

H. SNOWDEN MARSHALL,
*United States Attorney,
Attorney for Defendant.*

Office & P. O. Address, U. S. Court & P. O. Bldg., Borough of Manhattan, City of New York.

STATE OF NEW YORK,
*County of New York,
Southern District of New York, ss:*

John Z. Lowe, Jr., being duly sworn, deposes and says: I am the defendant above named and have read the foregoing Answer and know the contents thereof. The same is true of my own knowledge, except as to the matters stated therein to be alleged on information and belief, and as to those matters I believe it to be true.

JOHN Z. LOWE, JR.

Sworn to before me this 24 day of May, 1916.

[L. s.]

WALTER S. BEERS,
Notary Public, Etc.

[Endorsed:] L-14/300. Form No. 336. U. S. District Court, Southern District of New York. Southern Pacific Company, Plaintiff, versus John Z. Lowe, Jr., as Collector of Internal Revenue, Etc., Defendant. Answer to Amended Complaint. J. Snowden Marshall, United States Attorney, Attorney for U. S. Filed May 27, 1916. U. S. District Court, S. D. of N. Y.

At a stated term of the District Court of the United States for the Southern District of New York, held at the United States Court Rooms in the U. S. Court House and Post Office Building in the Borough of Manhattan, City of New York, on the 15th day of November, A. D. 1916.

Present: Honorable Martin T. Manton, District Judge.

L-14-300.

SOUTHERN PACIFIC COMPANY

vs.

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for
the Second District of New York.

Now comes the plaintiff by Gordon M. Buck, its attorney, and moves the trial of this cause. Likewise comes the defendant by Ben Matthews, Assistant U. S. Attorney. Counsel on both sides stipulate to try only the second cause of action. Thereupon a jury is duly impanelled and sworn, and the cause proceeds to trial. Thereafter, on Friday, November 17, 1916, at the close of the testimony on both sides, defendant's attorney moves to dismiss the complaint. Decision reserved. Defendant's attorney moves for a direction of a verdict. Decision reserved. Plaintiff's attorney moves for a direction of a verdict for \$183,615.97 and interest from August 13, 1915. Decision reserved. Thereafter, on Saturday, January 6, 1917, by direction of the Court judgment for the defendant on the second cause of action. See opinion on file. An extract from the minutes.

[SEAL.]

ALEX. GILCHRIST, JR.,

Clerk.

United States District Court, Southern District of New York.

Doc. L-14-300.

SOUTHERN PACIFIC COMPANY, Plaintiff,

v.

JOHN Z. LOWE, JR., as United States Collector of Internal Revenue
for the Second District of New York, Defendant.

It Is Hereby Stipulated and Agreed that the second cause of action set forth in the amended complaint herein may be tried separately from the first cause of action set forth in said complaint; and that the trial of the said first cause of action may be postponed, at the option of the plaintiff, until after the trial and final determination upon appeal or otherwise of the said second cause of action.

Dated New York, June 7, 1916.

GORDON M. BUCK,

Attorney for Plaintiff.

H. SNOWDEN MARSHALL,

*United States Attorney,**Attorney for Defendant.*

[Endorsed:] U. S. District Court, Southern District of New York.
Southern Pacific Company, Plaintiff, vs. John Z. Lowe, Jr., as Collector of Internal Revenue for 2nd Dist. of N. Y. Stipulation. Gordon M. Buck, for Plaintiff. Docket L-14-300. Filed June 7, 1916.
U. S. District Court, S. D. of N. Y.

At a Stated Term of the United States District Court, held in and for the Southern District of New York, at the United States Court and Post Office Building, in the Borough of Manhattan, City of New York, on the 15th day of November, 1916.

Present: Hon: Martin T. Manton, U. S. District Judge.

L-14-300.

SOUTHERN PACIFIC COMPANY, Plaintiff,
v.

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for
the Second District of New York, Defendant.

On motion of Gordon M. Buck, Esq., attorney for the plaintiff,
and B. A. Matthews, Esq., of counsel for the defendant, appearing
and not opposing, it is

Ordered that the title of this action be and the same is hereby
amended by striking out the word "as" following the name of the
defendant.

(S'g'd)

MARTIN T. MANTON,
U. S. D. J.

[Endorsed:] United States District Court, Southern District of
New York. Southern Pacific Company, Plaintiff, v. John Z. Lowe,
Jr., United States Collector of Internal Revenue for the Second Dis-
trict of New York, Defendant. Order. Gordon M. Buck, Attorney
for Plaintiff, No. 165 Broadway, Borough of Manhattan, City of New
York. Filed Nov. 16, 1916. U. S. District Court, S. D. of N. Y.

United States District Court, Southern District of New York.

No. 23.

SOUTHERN PACIFIC COMPANY, Plaintiff,
against

JOHN Z. LOWE, JR., as United States Collector of Internal Revenue
for the Second District of New York, Defendant.

Gordon M. Buck, of New York, attorney for Plaintiff.
H. Snowden Marshall, United States Attorney, for Defendant.
Ben. A. Matthews, of Counsel.

MANTON, D. J.:

The plaintiff has instituted this action alleging two causes of
action, seeking to recover in the first \$131,563.80 and in the second
\$183,882.64, taxes paid under the income tax law. By stipulation
between the parties only the second cause of action was litigated, the
first cause to await the outcome of the trial of the second.

This income tax was assessed against dividends received by the
plaintiff during the first six months of 1914. During this period,
the Central Pacific Railway Company, whose entire corporate stock
was held by the plaintiff, paid to the plaintiff four several dividends
aggregating \$18,361,597.43. These dividends were paid as follows:

Jan. 10, 1914, 20% on preferred stock.....	\$3,480,000.00
Jan. 10, 1914, 20% on common stock.....	13,455,100.00
Jan. 2, 1914, special dividend distributing proceeds of sale of land at Rockaway Beach sold in December, 1913.....	514,000.00
Jan. 13, 1914, regular 6% dividend.....	912,497.43

Making a total of..... \$18,361,597.43

This last item represents only the portion of the dividend paid on January 13, 1914, which the plaintiff claims exceeded the net earnings of the company during the period. The plaintiff is the holder of all or the large majority of stock of a number of railroad corporations, including the Central Pacific Railway Company, and forms a unified transportation system. The earnings of the companies are kept together with the plaintiff as the banker of the system. The Central Pacific Railway Company kept no bank account but its earnings were deposited with the bank accounts of the plaintiff. If the Railway Company needed money during this period for additions and betterments, the necessary funds were advanced by the plaintiff. This system was in practice prior to the declaration of the four dividends in question. In fact, the plaintiff has owned the entire capital stock of the Central Pacific Railway Company ever since the latter's incorporation, and from this it is claimed by the plaintiff that it became neither richer nor poorer by the declaration and payment of these dividends. Plaintiff further claims that the dividends in question were not earned during the period of taxation, to wit, the first six months of 1914.

It also claims that the proof warrants a finding that these dividends were paid from surplus resulting from the operations of the Railway Company prior to July 1, 1909, and that the net credits or debits to surplus for each of the fiscal years from 1910 to 1914 inclusive, shows no such earnings from which the dividends in question might be paid. The testimony of the plaintiff's accountants, together with its books, would indicate that the claim of the plaintiff was well founded so that it may be assumed that the two extraordinary dividends of 20% each on the preferred and common stock of the Railway Company, paid in January, 1914, and the extraordinary dividends of \$514,000 likewise paid on the preferred and common stock in January, 1914, must have been paid wholly out of the surplus accruing prior to July 1, 1909, and that at least \$2,313,234.20 of the 6% dividend paid on the common stock in June, 1914, must have been paid out of the surplus accruing prior to July 1, 1909.

Exhibit H shows the surplus on June 30, 1909, and the surplus at the close of each fiscal year up to and including June 30, 1914. On June 30, 1909, the Railroad Company had a surplus of \$25,250,361. Dividends paid during the next five fiscal years according to the plaintiff's books of account, indicate no such amount in the profit and loss account as would permit of the payment of the dividends in question. It is therefore reasoned by the plaintiff that these moneys paid in dividends must have been paid out of the surplus which accrued prior to July 1, 1909, but how this surplus is made up, whether from earnings of the company or increase in value of land, does not appear. The learned counsel for the plaintiff claims "it follows, therefore, that all three of the extraordinary dividends must have been paid from surplus and that all of the four dividends must have been paid from surplus except \$1,727,295.80, the difference between the sum last mentioned and the amount of the dividend, or \$2,313,234.20 is the amount which must have been paid from surplus." The burden of proof was upon the plaintiff to establish a payment from

the capital, not from income as dividends. This burden it has failed to sustain.

When this tax was levied, a protest was made and a hearing had before the Treasury Department, a brief was submitted in behalf of the plaintiff and after an adverse ruling before the Department, the plaintiff, under protest, paid the tax and now brings this action to recover the moneys so paid.

The Act of October 3, 1913, provides:

"G. (a) That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year, to every corporation.

(b) Such net income shall be ascertained by deducting from the gross amount of the income of such corporations, * * * received within the year from all sources, (first) all ordinary and necessary expenses paid within the year * * *; (second) all losses actually sustained within the year * * *; (third) the amount of interest accrued and paid within the year * * *; (fourth) all sums paid by it within the year for taxes * * *.

(c) The tax herein imposed shall be computed upon its entire net income accrued within each preceding calendar year ending December 31st; * * *."

The Sixteenth Amendment of the Constitution gave Congress the power to lay and collect taxes on income from whatever source derived, without apportionment among the several states, without regard to any census or enumeration. This has been held to be constitutional. (*Brushaber v. Union Pacific*, 240 U. S. 1; *Stanton v. Baltic Mining Co.*, 240 U. S. 103.) The application of this statute presents two questions: first, whether the dividends in question may properly be considered a part of the gross income of the plaintiff, and second, whether such dividends were received within the year.

The plaintiff advances the claim that these moneys paid in dividends came from surplus earnings and because they were surplus they were, in fact, an addition to and a part of the capital of the Railway Company, and that they were in no sense income.

The defendant contends that they constitute income received within the year. The plaintiff says that because of the method of book-keeping and the manner of handling the moneys of the Central Pacific Railway Company, in truth and in fact, the money was in the actual possession of the plaintiff at all times. Be this as it may, if it was money earned by the Railway Company's capital, because the physical possession and books of account represented it as the plaintiff's property by reason of possession, nevertheless, it does not change the ownership of the property for legally it was the property of the Railway Company and that Company was entitled to all the rights of ownership. Therefore, when its Board of Directors permitted the income to accumulate into a surplus so large that at a later day it was justified in declaring special dividends, I think it was still income for the stockholders to which they could only become entitled when the dividends were declared.

I do not think that income as used in the statute should be given

meaning so as to include everything that comes in. The true function of the words "gains" and "profits" is to limit the meaning of the word "income" and to show its use only in the sense of receipts which constituted an accretion to capital. So the function of the word "income" should be to limit the meaning of the words "gains" and "profits." The increased value of capital as such constitutes in one sense a gain or profit, but not income. Hence, such gain or profit is not taxable but only such profits and gains as constitute income are taxable. This in substance was what the court held in *Gray v. Darlington*, (15 Wall, 63) and in *Gauley Mt. Coal Co. v. Hays*, (230 Fed. 110).

In the early case of *People v. Davenport* (30 Hun. 177) it was said that "income is that which capital earns remaining itself intact." This definition was recently adopted in *Mitchell v. Doyle* (225 Fed. 437).

While these moneys remained as surplus of the Central Pacific Railway Company, they were subject to legitimate use by order or direction of the Board of Directors of that company. They were part of the gains or profits of that company and its business was the operation of a railroad. Although the plaintiff held the entire stock of this company, it gave it no right to the surplus or earnings. Indeed, they could only declare a dividend by order of the Board of Directors of the Railway Company, so that the plaintiff's right to possession of the moneys came only when a dividend was declared, to wit, within the taxing period, the first six months of 1914. If these dividends were not received on the dates they were declared and paid, then when were they received?

The Government cannot tax undistributed surplus as income to the stockholders because they were income to the stockholder when paid and not before. While it may be that the plaintiff owning all of the capital stock of the Central Pacific Company could have begun some action to have disbursed the surplus, still it did not do so. The accumulation of surplus of itself does not entitle stockholders to dividends. (*N. Y. & C. R. v. Nickala*, 119 U. S. 296; *Gibbons v. Mahon*, 136 U. S. 549; *St. John v. Erie*, 21 Wall, 136; *Union Pacific v. Frank*, 226 Fed. 906; *Park v. Grant Locomotive Works*, 40 N. J. Equity, 114.)

Indeed, the granting of dividends is entirely in the discretion of the directors and in the absence of fraud their action is not subject to review by the Courts. (*Wilson v. Amer. Ice Co.* 206 Fed. 736; *Cook on Corporations*, 6th Ed. §545.)

A stockholder has no interest in the profit of a corporation until a dividend has been declared. (*Humphreys v. McKissock*, 140 U. S. 304; *U. S. Radiator Co. v. N. Y.* 208 N. Y. 144.)

Often receipts come in which are but a change of capital investment or which represent a distribution of capital assets. In that case, there is no gain or profit. If such receipts were regarded as income, the taxpayers' capital is depleted. Such was the reasoning in the case of *Lynch v. Hornby and Lynch v. Turriah*, decided March, 1916 in the Circuit Court of Appeals (Eighth Circuit).

From the evidence here, from all that appears, the surplus fund upon which the dividends have been declared are not shown to be

other than earnings of the railway company, or gains and profits. Counsel has argued differently in his brief, but no where does his testimony or statements warrant a finding that this surplus is an increase to capital by a year to year enhancement of the value of the capital of the Railway Company and is not from any enhancement of the value of land or property of the corporation.

In *Stanton v. Baltic Mining Co.* (240 U. S. 103), the Supreme Court held a mining company obligated to pay a tax on sales of its ore.

In the case of *Edwards v. Keith* (231 Fed. 111, Second Circuit), the plaintiff was a life insurance agent employed by an insurance company under written contract to procure applications for insurance on the lives of individuals. As compensation for his services, the insurance company was obligated to pay him a certain commission on the first premium paid by the assured when the policy was issued. It was further obligated as the assured paid subsequent renewal premiums for a certain number of years, to pay the plaintiff a stated commission on each of such renewal premiums. It was on these renewal premiums, or rather on the commission paid thereon, that a tax was levied. Judge Lacombe said:

"If, as counsel retained for the purpose, a lawyer argues a case for a client before the Court of Appeals in October, 1915, having received a retainer in August and his work being completed with the argument, and the cause is decided in December and his client pays him in February, 1916, we cannot see why he should not include his retainer in his income returned for 1915 and the money paid him for argument in his return for 1916, although in that year (1916) he did nothing—did not even send in a bill, having done that in December, 1915."

And further illustrating, the Court said:

"If as a reward for long and faithful service an industrial corporation votes to one of its employees, who retires from active work, an annual pension, we do not see why all instalments of that pension paid in each calendar year are not, under the statute, income for that year."

And further:

"It may be noted that, although fully earned by work already done, there is no certainty that the sum conditionally promised for the ensuing year will ever be paid or will accrue or come due; John Doe may die within the first year, or at its expiration may refuse to renew his policy in which event the company is not obligated to pay its agent anything beyond the amount already paid him; the obligation to pay does not arise until John Doe actually pays his renewal premium in cash.

In the case at bar, there is no certainty when the surplus from which the dividends were paid were earned or that such surplus would ever be distributed as dividends. Financial reverses or some other calamity might have destroyed the surplus and the Central Pacific Company could not have distributed the earnings to the plaintiff and the plaintiff would have no right of action against this Railway Company for the amount of such loss or surplus.

In *Stratton's Independence v. Howbert &c.* (231 U. S. 399), the Court said:

"It was reasonable that Congress should fix upon gross income, without distinction as to source, as a convenient and sufficiently accurate index of the importance of the business transacted. * * * Moreover, Congress evidently intended to adopt a measure of the tax that should be easy of ascertainment and simply and readily applied in practice."

Judge Thomas in *Conn. Mutual Life Ins. Co. v. Eaton* (218 Fed. 206), held that under the Act of 1909, taxation is limited to such income as was actually received during that year, and does not include items which may have been earned or have become due but have not been collected. This case was affirmed on appeal in this Second Circuit.

In *Herold v. Metropolitan Life Ins. Co.* (201 Fed. 918), Judge Cross, in the Third District, said:

"If they do not arise from income received during the tax year, but from income received during a previous year, Congress has not taxed them * * * more than once. Concededly, they have been taxed once with the other net income of the particular year during which the company actually received them in cash."

It must be remembered that the tax here is charged upon the plaintiff which received the dividends and not the corporation which paid them. The phraseology of the statute provides for the gross amount of the income of such corporation "received within the year from all sources" and permits of deduction of (1) all the ordinary and necessary expenses paid within the year; (2) all losses actually sustained within the year; (3) the amount of interest accrued and paid within the year; and (4) all sums paid by it within the year for taxes.

Since these dividends were received within the six months and were paid as part of the gross income to the plaintiff as the stockholder of the Railroad Company, and were received within the year "from all sources", I am of the opinion that the collector was right in levying this assessment and collecting this tax, and accordingly there must be judgment directed for the defendant on the second cause of action.

Dated, New York City, January 8th, 1917.

MANTON, U. S. D. J.

United States District Court, Southern District of New York.

L. 14/300.

SOUTHERN PACIFIC COMPANY

v.

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for the Southern District of New York.

Judgment.

The issues in this action having been regularly brought on for trial before the Honorable Martin T. Manton, Judge, and a Jury, at a

Stated Term of this Court held on the 15th day of November, 1916, at the U. S. Courts and P. O. Building, in the Borough of Manhattan, City of New York, and the plaintiff herein appearing by Gordon L. Buck, Esq., its attorney, and the defendant appearing by Benjamin Matthews, Esq., Assistant U. S. Attorney, and the attorneys for both parties having stipulated to try only the second cause of action, the first cause to await the outcome of the trial of the second, and the allegations and proofs on behalf of the plaintiff and defendant on the said second cause of action having been heard and considered thereafter on November 17, 1916, at the close of the testimony on both sides, defendant's attorney having moved to dismiss the complaint, and decision having been reserved, the said attorney for the defendant further moved for the direction of a verdict for the defendant, and the attorney for the plaintiff having moved for a direction of a verdict for the plaintiff, and thereafter the Honorable Court having directed a verdict for the defendant on the second cause of action; and a verdict having been entered accordingly, and the costs of the defendant having been taxed in the sum of Fifty-six & 85/100 Dollars by the Clerk of this Court,

Now, on motion of H. Snowden Marshall, United States Attorney for the Southern District of New York, attorney for the defendant, it is

Ordered and adjudged that the defendant herein, John Z. Lowe, Jr., Collector of Internal Revenue for the Second District of New York, have judgment herein on the merits as to the second cause of action, and that the said defendant recover of the plaintiff, Southern Pacific Company, the sum of Fifty-six & 85/100 (\$56.85) Dollars, costs as taxed, and that the defendant have execution therefor.

Judgment signed this 14th day of March, 1917.

ALEX. GILCHRIST, JR., Clerk.

SIR: You will please take notice that a — of which the within a copy, was this day duly entered in the within-entitled action, in the office of the Clerk of the —.

Dated N. Y., March 14, 1917.

Yours, etc.,

U. S. Attorney,
Attorney for Defendant.

To

Attorney for ———.

[Endorsed:] L. 14/300. Form No. 336. U. S. District Court Southern District of New York. Southern Pacific Company vs. John Z. Lowe, Jr., United States Collector of Internal Revenue of the Southern District of New York. Judgment with Notice of Settlement. L. 14/300. H. Snowden Marshall, United States Attorney, Attorney for Def't. Due service of a copy of the within is hereby admitted. New York, ———, 19——, ———, Attorney for ———. To ———, Attorney for ———. Filed Mar. 14, 1917, 1.10 P. M. U. S. District Court, S. D. of N. Y.

United States District Court,

1

SOUTHERN DISTRICT OF NEW YORK.

SOUTHERN PACIFIC COMPANY,
Plaintiff,

VS.

JOHN Z. LOWE, JR., United
States Collector of Internal
Revenue for the Second Dis-
trict of New York,
Defendant.

L-14-300.

2

BE IT REMEMBERED that on the 15th day of November, 1916, the above-entitled cause came on for trial before the above Court, and a jury duly empanelled, Hon. Martin T. Manton presiding. The plaintiff appeared by Mr. Gordon M. Buck, its attorney, and the defendant by Mr. H. Snowden Marshall, United States Attorney (Mr. Ben A. Matthews, of Counsel), attorney for defendant, and the following proceedings were had, viz.:

Mr. Buck opened the case to the jury on behalf of the plaintiff, and Mr. Matthews on behalf of the defendant.

MR. BUCK: Before proceeding to offer evidence, your Honor, I move to amend the title of this action

- 4 by striking out the word "as" following the name of the defendant in the title hereof, so that the defendant named may be:

"John Z. Lowe, Jr., United States Collector
"of Internal Revenue for the Second District
"of New York."

THE COURT: That motion is granted.

MR. MATTHEWS: I have no objection.

If your Honor please, I now move that the complaint in this action be dismissed on the ground that it does not state facts sufficient to constitute a cause of action.

- 5 THE COURT: Yes. I suppose that raises the whole question.

MR. MATTHEWS: Well, I want to be certain to make up here a full and complete record in case this proposition gets before another Court.

THE COURT: Well, I will deny your motion at this time and give you an exception.

MR. MATTHEWS: Exception.

- 6 A duly certified copy of the Income Tax return of the plaintiff for the six months' period ending June 30, 1914, together with accompanying protest, was offered by the plaintiff and received in evidence without objection and marked Plaintiff's Exhibit 2-A. Exhibit 2-A was read to the jury and a copy of this Exhibit so far as is material is hereto annexed and made a part hereof.

Letter addressed to the plaintiff, under date of May 15, 1915, by the Commissioner of Internal Revenue, notifying the plaintiff that an additional assessment for 1914 had been recommended against it, which would result in an additional tax of \$192,395.81, was offered by

the plaintiff and received in evidence without 7
objection and marked Plaintiff's Exhibit 2-B.
Exhibit 2-B was read to the jury and a copy
of this Exhibit so far as is material is hereto
annexed and made a part hereof.

Mr. BUCK: With Mr. Matthews' consent, and
without being sworn, I make the following state-
ment:

I made the argument before the Commissioner of
Internal Revenue against this proposed additional
assessment referred to in this letter, a few days
before this letter was written, and at that time sub-
mitted to the Treasury officials the printed brief 8
that I hold in my hand, and also made oral argu-
ment which substantially covered the same points.

This printed brief was offered by the plaintiff
and received in evidence and marked Plaintiff's
Exhibit 2-C.

The substance of Exhibit 2-C was stated to
the jury, but this Exhibit is not set forth here-
in owing to the stipulation hereinafter con-
tained.

A duly certified copy of notice dated
August 4, 1915, received by the plaintiff from
the defendant, that a tax of \$192,218.19 had 9
been assessed upon its net income for the period
ending June 30, 1914, and that unless paid on
or before August 14, 1915, it would be the
defendant's duty, under the law, to collect the
same, with five per cent. additional, and in-
terest at one per cent. a month until paid, and
the protest accompanying the payment of the
said tax were offered separately by the plain-
tiff and received in evidence without objection
and read to the jury and marked Exhibit 2-D.

- 10 A copy of this exhibit so far as material is hereto annexed and made a part hereof.

MR. BUCK: I personally paid that tax and delivered a certified check to the order of the defendant, delivered it to him, on August 13, 1915, together with the original protest, of which Exhibit 2-D is a copy.

MR. MATTHEWS: It is conceded at this time by the defendant that the tax just referred to was paid under proper protest.

- 11 Duly certified copy of claim for refund of the additional tax sought to be recovered in this action, claiming a refund in the sum of \$183,882.64 was offered by the plaintiff and received in evidence without objection, and read to the jury and marked Plaintiff's Exhibit 2-E. A copy of Exhibit 2-E so far as material is hereto annexed and made a part hereof.

- 12 It is stipulated by the parties hereto that the protest accompanying the plaintiff's return of net income (Exhibit 2-A), the protest accompanying the payment of the tax (Exhibit 2-D), the printed brief (Exhibit 2-C) submitted to the Commissioner of Internal Revenue in opposition to the additional assessment, and the claim for refund (Exhibit 2-E) were due and proper, and sufficiently raise and state all the grounds of objection upon which motions for a directed verdict were made by the plaintiff as hereinafter set forth.

13 A duly certified copy of a letter from the Acting Commissioner of Internal Revenue, rejecting the plaintiff's claim for a refund of the amount of \$183,882.64, was offered by the

plaintiff and received in evidence without objection and read to the jury and marked Plaintiff's Exhibit 2-F. A copy of this Exhibit 2-F so far as material is hereto annexed and made a part hereof. 13

A stipulation between the parties to this action was offered by the plaintiff and received in evidence without objection and marked Plaintiff's Exhibit 2-G.

This stipulation was read to the jury and is as follows, viz.:

[Entitled in this Action.]

14

"IT IS STIPULATED AND AGREED by and between the parties hereto that the following facts may be deemed to have been proved upon the trial of this action, viz.:

"1. That the Central Pacific Railway Company is the successor of the Central Pacific Railroad Company and acquired all of the properties of the latter Company by purchase in the year 1899; and that the said Railway Company has assumed all the duties and obligations and has been subrogated to all the rights and benefits of the said Railroad Company under the terms of the lease between the Company last mentioned and the Southern Pacific Company. 15

"2. That the Southern Pacific Company now owns, and has continuously, since the incorporation of the said Central Pacific Railway Company in the year 1899, owned, all of the capital stock of the said Railway Company, including

6

Frederick Van Note—Direct.

- 16 the stock registered in the names of the directors.

“3. That the additional tax of \$183,882.64 referred to in paragraph numbered XII of the Answer to the Amended Complaint herein was assessed upon an amount equal to the first four dividends referred to in paragraph numbered Twelfth of the said Amended Complaint plus an amount equal to \$912,497.48 of the fifth dividend referred to therein.

Dated, New York, October 9, 1916.

- 17 “(Signed) GORDON M. BUCK,
 Attorney for Plaintiff.
 “(Signed) H. SNOWDEN MARSHALL,
 Attorney for Defendant.”

FREDERICK VAN NOTE, a witness called on behalf of the Plaintiff, being first duly sworn, testified as follows:

DIRECT-EXAMINATION BY MR. BUCK:

- 18 My occupation is Chief Clerk in the Controller's office of the Southern Pacific Company. Plaintiff's Exhibit 2-B (a letter from the Commissioner of Internal Revenue to the Southern Pacific Company, dated May 15, 1915, stating that the recommendation of the Internal Revenue Agent that an additional assessment be made against the Southern Pacific Company for the six months ending June 30, 1914, of a little more than One hundred and ninety-two thousand dollars, had been approved) contains this statement: “It appears that you have been informed as to the basis upon which

Frederick Van Note—Direct.

these proposed assessments were to be made." The Southern Pacific Company was so informed. That information was given to me orally shortly before the receipt of this letter. The Examiner of the Treasury came and asked for a copy of the return, and I gave him a copy of the return ending June 30, 1914, and when he saw the notation on the bottom that we had excluded dividends that had been declared out of a surplus accruing prior to January 1, 1913, he stated that they would recommend that an assessment be made on account of those dividends. I then gave him a statement showing the detail of the dividends that we had excluded from our return. This is the statement that I handed the Internal Revenue Examiner.

MR. BUCK: I offer the statement in evidence and ask that it be marked Plaintiff's Exhibit 2-H.

MR. MATTHEWS: I object to the statement on the ground that it is a self-serving declaration, and is not competent evidence of the facts purported to be therein set forth and made by the Southern Pacific Company's bookkeeper.

THE COURT: What is it?

MR. BUCK: The statement is offered for the purpose of showing upon what this additional assessment was made. The letter, Plaintiff's Exhibit 2-B, which I have offered in evidence, from the Commissioner to the Southern Pacific Company, simply stated that he was going to make an additional assessment, and then it concludes in this way: "It appears that you have been informed as to the basis on

Frederick Van Note—Direct.

22 which these proposed assessments are to be made", and I want to prove now what that information was.

THE COURT: Is this it?

23 MR. BUCK: The Internal Revenue Examiner came to the Southern Pacific's office, as Mr. Van Note has testified, and asked to see the return of the annual net income and when the latter showed him a copy of it with a foot note at the bottom, stating that these dividends paid out of surplus had been excluded, the examiner asked him then for a statement of those dividends, and that is the statement which Mr. Van Note gave him, showing the dividends which had been excluded; and the examiner copied that statement and gave it back to Mr. Van Note.

THE COURT: Was it on that statement which they eventually fixed the taxation?

MR. BUCK: Yes, sir.

THE COURT: Is that the fact?

MR. MATTHEWS: I don't know whether that is the fact or not.

THE COURT: Is it on this statement that subsequently a taxation was fixed?

24 THE WITNESS: Yes, sir, as far as these dividends which are in dispute here are concerned.

THE COURT: And this taxation which is in dispute?

THE WITNESS: Yes, sir.

THE COURT: I will take it.

MR. MATTHEWS: I do not see what relation those companies whose dividends were received

Frederick Van Note—Direct.

have with this case. I think the third column 25
only is involved.

MR. BUCK: I think that is so.

THE COURT: Very well. I will take it.

MR. MATTHEWS: I also object, and I would
like to have this ground of objection incorpo-
rated in the record, namely, on the ground
that, if it should appear by the evidence that
the Southern Pacific had other income which
was not included in its return besides the
dividends referred to in the exhibit offered, it
would nevertheless be liable to a tax on such
income, to the extent thereof, and that the 26
Government is not bound by this exhibit, or
by the assessment on the basis of the figures
stated in that exhibit, or in the Commissioner's
letter which was offered in evidence yester-
day.

The statement offered by the plaintiff was
received in evidence and read to the jury and
marked Plaintiff's Exhibit 2-H. A copy of
this Exhibit is hereto annexed and made a
part hereof.

MR. MATTHEWS: Exception.

MR. BUCK: This is a statement of dividends 27
that were excluded from the plaintiff's Income
Tax return for the six months period ending
June 30, 1914. I referred before to certain divi-
dends, and this is a statement of those divi-
dends. The plaintiff was informed that the
additional assessment was made upon the divi-
dends in question.

Q. Plaintiff's Exhibit 2-B, letter from the Com-
missioner of Internal Revenue, refers to the pro-
posed additional assessment, the assessment recom-

Frederick Van Note—Cross.

29 mended for 1914, as being \$192,395.81, while the assessment that was actually made was \$192,218.17, being a difference of one hundred and seventy-seven dollars and a few cents. Will you please explain what that difference was?

MR. MATTHEWS: I object. How can this witness tell what the difference between the amount recommended and the amount assessed was? The Southern Pacific here is to prove that the income taxed was not received.

MR. BUCK: I will withdraw the question. It is not material anyway.

20

CROSS-EXAMINATION BY MR. MATTHEWS:

Exhibit 2-H was prepared by a clerk in my employ, from the balance sheet of the plaintiff, showing the dividends that had been received during the six months ending June 30, 1914, and from that we made—that is the difference between the amount shown on the balance sheet and the amount we recorded on our return to the Government, which represented the amount we had excluded. I have not that balance sheet in court.

30

THE COURT: Was that a balance sheet issued in the regular course of business?

That balance sheet appears in the annual report of 1914, condensed, but not in detail.

MR. BUCK: I have some depositions here that were taken in California before Mr. Hugh T. Sime, a notary public, and the appearances at that time were Mr. H. W. Hobbs, Mr. Guy V. Shoup on behalf of the plaintiff, and Mr.

B. A. Matthews on behalf of the defendant, 81
the witnesses all living more than a hundred
miles from the place of trial, as shown by the
certificate of the notary public.

MR. MATTHEWS: I think, perhaps, we can
save some time by raising some questions that
will come up shortly, if we get into these
depositions now. Of course, I am going to
object to going back of the corporate entity of
the Southern Pacific Company to determine the
sources of those dividends. That raises, per-
haps, the principal question in the case. If
we do get back of that corporate entity then 82
this question will probably arise as to how we
shall determine when the surplus out of which
these dividends were paid was earned.

THE COURT: Well, on this motion that is
now before the Court, I think I shall take this
testimony and if there are questions here for
the jury, I will instruct the jury with regard
to the testimony. I will deny your motion for
the present and you may renew it later on.

MR. MATTHEWS: May I register my objec-
tion to all of this testimony on the grounds
stated in the argument that has been submit-
ted to your Honor, and note my exceptions to 83
the rulings of the Court.

It is stipulated that the grounds of objec-
tion stated in the argument were substantially
those hereinafter set forth to the evidence con-
tained in the depositions.

THE COURT: Yes, I will deny your motion
at this time, subject to a motion to strike out
later.

Testimony of G. L. King—Direct.

34 **MR. MATTHEWS:** Exception.

MR. BUCK: I will read the deposition of
 Mr. G. L. King:

"TESTIMONY OF G. L. KING:

"DIRECT-EXAMINATION BY G. V. SHOUP:

**"I have been the Secretary of the Central Pacific
 Railway Company since January 23, 1909. I re-
 side in Oakland, California. My place of business
 is Flood Building, San Francisco. As such Secre-
 tary, I have the custody and control of the books of
 the Central Pacific Railway Company, showing the
 minutes of the meetings of the Board of Directors
 of that Company.**

35 **"Q. Have you examined the books of the Central
 Pacific Railway Company for the purpose of ascer-
 taining whether resolutions were passed declaring
 certain dividends, namely, extra dividends of
 twenty per cent. payable out of the earnings accu-
 mulated prior to January 1, 1913, and payable on
 January 10, 1914?"**

36 **MR. MATTHEWS:** Objected to on the ground
 that it is incompetent, irrelevant and immat-
 terial, and on all the grounds and for all the
 reasons stated in the argument presented to
 the Court before this deposition was read.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

"A. I have examined them."

MR. BUCK: I offer in evidence the stipula-
 tion that Mr. Matthews entered into with me
 in regard to some objections that were made;
 he objected to certain minutes and statements

Testimony of G. L. King—Direct.

that were offered in evidence, on the ground 87
that they were certified copies of the minute
books and of the books of account and not the
books themselves, and I stated I would bring
the books on from California, if he demanded
them, and he withdrew his objection.

THE COURT: Do you insist upon the produc-
tion of the originals?

MR. MATTHEWS: No, but as to the other
points, I object.

Stipulation above referred to was offered by
the plaintiff and received in evidence and
marked Plaintiff's Exhibit 2-I. This Exhibit 38
was read to the jury and a copy is hereto an-
nexed and made a part hereof.

"Q. I hand you what purports to be a copy of a
resolution passed by the Board of Directors of the
Central Pacific Railway Company, December 29,
1913, declaring an extra dividend of twenty per
cent. payable out of the earnings accumulated prior
to January 1, 1913, upon the outstanding preferred
capital stock, and payable on January 10, 1914, and
ask you if that is your certificate?"

MR. MATTHEWS: I would like the record to
show that I object to that question. I really 39
don't think the question should go before the
jury in this case. The question I think cor-
rectly states the wording of the resolution. I
simply don't want the resolution before the
jury. I want to object to the resolution, I
think it is incompetent, irrelevant and imma-
terial, and on all the grounds stated in the
argument, and also that it is in the nature
of a self-serving declaration.

Testimony of G. L. King—Direct.

40 **THE COURT:** Objection overruled.
 MR. MATTHEWS: Exception.

 “A. It is. The resolution appears upon the minutes of the Board of Directors of the Central Pacific Railway Company as therein set forth.”

MR. BUCK: I offer in evidence the certified copy of the resolution referred to by the witness, and ask that it be marked Plaintiff's Exhibit A.

41 **MR. MATTHEWS:** Objected to on the ground that it is not the best evidence (subject to stipulation, Exhibit 2-1) and the facts therein contained are incompetent, irrelevant and immaterial, for the reason that the issue in this case is whether the Southern Pacific Company received certain income within the six months ending June 30, 1914, and has nothing to do with the source of dividends paid by the Central Pacific Railway Company, and to that I would like to add all the grounds and reasons stated in my argument to the Court this morning before the deposition was read.

THE COURT: Yes. Objection overruled.
43 **MR. MATTHEWS:** Exception.

 The resolution above referred to was received in evidence and marked Plaintiff's Exhibit A. This exhibit was read to the jury and a copy is hereto annexed and made a part hereof.

 “The paper handed me is a true and correct copy of a resolution passed December 29, 1913, declaring extra dividend of twenty per cent. payable out of the earnings accumulated prior to January 1,

Testimony of G. L. King—Direct.

1913, upon the outstanding common capital stock of the Central Pacific Railway Company, payable on January 10, 1914. I have compared that copy with the resolution as it appears in the minutes of the Board of Directors." 43

MR. BUCK: I offer that copy in evidence, and I ask that it be marked Plaintiff's Exhibit B.

MR. MATTHEWS: Objected to on the same grounds stated before.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The resolution last referred to was received in evidence and marked Plaintiff's Exhibit B. This exhibit was read to the jury and a copy is hereto annexed and made a part hereof. 44

"The paper handed me is a true and correct copy of a resolution adopted by the Board of Directors of the Central Pacific Railway Company, December 23, 1913, authorizing and approving the sale of the Rockaway Point property, and declaring a dividend of \$514,000, payable January 2, 1914. I have compared that resolution with the resolution appearing upon the books of the Central Pacific Railway Company." 45

MR. BUCK: I offer in evidence that certified copy of the resolution and ask that it be marked Plaintiff's Exhibit C.

MR. MATTHEWS: Objected to on the ground it is not the best evidence (subject to Exhibit 2-I) and further on the ground it is immaterial, incompetent and irrelevant, and particularly for the reason that the issue in this case is as

Testimony of G. L. King—Direct.

46 to the income received by the Southern Pacific Company and not as to the source of dividends paid to the Southern Pacific by the Central Pacific, or corporations in which the Southern Pacific owns stock.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The resolution last referred to was received in evidence and marked Plaintiff's Exhibit C. This exhibit was read to the jury and a copy is hereto annexed and made a part hereof.

47 MR. BUCK: This is a resolution declaring a dividend of \$514,000 ratably on the preferred and common capital stock of the Central Pacific, payable in January, 1914, out of the proceeds of the sale of some property at Rock-away Point.

48 "The paper handed me is a true and correct copy of a resolution adopted by the Board of Directors of the Central Pacific Railway Company, June 13, 1914, declaring a dividend of six per cent. upon the outstanding common capital stock of the Central Pacific Railway Company, payable June 13, 1914. I have compared that copy with the resolution as it appears upon the books of the Central Pacific Railway Company."

MR. BUCK: I now offer this copy of the resolution in evidence and ask that it be marked Plaintiff's Exhibit D.

MR. MATTHEWS: Objected to on the ground that it is not the best evidence (subject to Exhibit 2-I), and on the further ground that it is irrelevant, incompetent and immaterial.

Testimony of G. L. King—Direct.

THE COURT: Objection overruled.

49

MR. MATTHEWS: Exception.

The resolution last referred to was received in evidence and marked Plaintiff's Exhibit D. This Exhibit was read to the Jury and a copy is hereto annexed and made a part hereof.

"**MR. SHOUP:** Will state to the counsel for the Government that the original books of the Central Pacific Railway Company, showing and containing such resolutions, are in the custody of Mr. King, in this building, and of course will be subject to inspection of counsel for the Government at any time that he may desire to examine them."

50

"I was Secretary of the Central Pacific Railway Company at the time of the passage of each of these resolutions and was personally present at the time of their passage. I can state that the resolutions were in fact passed as they appear upon the books.

"The originals of the printed document handed me, containing copies of certain agreements between the Central Pacific Railroad Company and the Southern Pacific Company of various dates, providing for the operation by the Southern Pacific Company of the railroad properties of the Central Pacific Railway Company, were destroyed in the fire of April, 1906, at the time of the earthquake in San Francisco. I have no duplicates of the originals of those leases in my possession now. We have never been able to find any originals of such leases. I consider the printed copies which have just been handed to me are correct copies of the original documents. I have seen the original documents. From my knowledge of the original docu-

51

Testimony of G. L. King—Direct.

12 ments, the printed copies which have been handed to me are correct copies. They are the copies which have been acted upon by the Central Pacific and the Southern Pacific as being correct in the transaction of their business affecting such leases. They have been accepted by both companies without question."

53 **MR. BUCK:** I now offer in evidence the printed copies of the agreements referred to in the testimony of the witness, namely, the amendment to the lease between the Central Pacific Railroad Company and the Southern Pacific Company, dated December 7, 1893, and the agreement dated the 22nd of March, 1894, by and between the Central Pacific Railroad Company and the Southern Pacific Company, and the agreement dated April 15, 1897, by and between the Central Pacific Railroad Company and the Southern Pacific Company, and ask that these agreements be considered as one offer, and marked Plaintiff's Exhibit E. I do not offer in evidence the agreement dated February 17, 1885, between the Southern Pacific and the Central Pacific Railroad Company for the reason that, so far as the issues in this case are concerned, the agreements which I have offered in evidence cover all the points involved.

54

MR. MATTHEWS: Objected to on the ground that the agreements are incompetent, irrelevant and immaterial and on the ground that the copy offered is not the best evidence of those agreements. I would also like to make further objection to the introduction of evidence of them as agreements after examining them.

Testimony of G. L. King—Direct.

THE COURT: What about the originals of 55
those?

MR. BUCK: The testimony I have here shows that they were destroyed in the San Francisco fire.

MR. MATTHEWS: Well, I would like to ask here what the purpose is of the offer. If Mr. Buck will state that a little more fully than he did.

MR. BUCK: I have two purposes in offering it: one is that hereafter I wish to make proof of the income of the Central Pacific, and in that connection shall show, or expect to show, that 56
these properties were operated under a lease.

I furthermore wish to show that the Southern Pacific had actual, physical possession of all the railroads and appurtenant properties, all the cash of the Central Pacific; in other words, it absolutely possessed all the assets of the Central Pacific long prior to the declaration of those dividends that are in controversy here. The Central Pacific had no bank account, and all its moneys were deposited in the Southern Pacific's bank accounts, and the Southern Pacific made no distinction between its own funds and those of its subsidiary corporation; that 57
entries were made in the books of the two companies, and when those dividends were paid the payment was merely constructive and was effectuated by book entries; and I simply want to show the extremely technical nature of the Treasury Department's ruling in using as a basis for the ascertainment of income, the constructive payment of dividends when we had possession of all these assets for years prior to

Testimony of G. L. King—Direct.

58 that time. So that I have a double purpose in offering the lease in evidence.

MR. MATTHEWS: I repeat my objection as stated.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The agreements so offered were received in evidence and marked Plaintiff's Exhibit E. This exhibit was read to the jury and a copy is hereto annexed and made a part hereof.

59 "As such Secretary of the Central Pacific Railway Company, I have the custody and control of the records of the Central Pacific Railway Company regarding the stock issued by the Central Pacific Railway Company. The statement handed to me has been compared by me with the records of the Central Pacific Railway Company, and correctly shows the names of the stockholders, the numbers and dates of certificates, number of shares and other items as they appear upon the records of the Central Pacific Railway Company.

60 "This statement shows that preferred stock was issued to the Southern Pacific Company by certificates dated January 25, 1911, and November 23, 1911; these are new issues of stock. This statement contains a true and correct copy of the entries as they appear upon the stock record."

MR. BUCK: I offer this statement in evidence and ask that it be marked Plaintiff's Exhibit F.

MR. MATTHEWS: We have stipulated with reference to that stock, but I want on the record that my stipulation as to the stock owner-

Testimony of G. L. King—Cross.

ship is as to the fact, and I don't want to be 61
understood as waiving my objection to the evi-
dence tending to show the sources of those
dividends.

THE COURT: Yes.

The statement so offered was received in
evidence and marked Plaintiff's Exhibit F.
This exhibit was read to the jury and a copy is
annexed and made a part hereof.

MR. MATTHEWS: I will now read the cross-
examination:

62

"CROSS-EXAMINATION BY MR. MATTHEWS:

"MR. MATTHEWS: By cross-examining this
witness, may it be understood that I do not
waive any of the objections heretofore taken to
his testimony.

"MR. SHOUP: That is agreeable.

**"This statement is of September 1, 1916. The
same condition of stock ownership existed as of
June 30, 1910, and July 1, 1914, with the exception
of the directors' stock and certain preferred stock.
Those directors' shares amounted to only three or
four. The same condition also existed with the 63
exception of a few shares held by directors, on
January 1, 1914, and on January 1, 1913, and also
on March 1, 1913."**

MR. MATTHEWS: At this point, your Honor,
in the taking of the deposition I made an addi-
tional objection to Exhibit C. I think to
understand my objection I had better hand
that exhibit up to your Honor.

Testimony of T. O. Edwards—Direct.

64 **MR. BUCK:** I consent, your Honor, that that part of the record be stricken out.

MR. MATTHEWS: I objected specifically to that portion of Exhibit C and separately to that portion (indicating) beginning with the words, "The President stated" and ending with the words, "declared as a dividend."

THE COURT: Is that the part you consent to strike out?

65 **MR. BUCK:** Everything prior to "On motion duly seconded" and beginning with the words, "The President stated," and ending with the words, "declared as a dividend". I only want to show the payment of the dividend.

THE COURT: Is that all right?

MR. MATTHEWS: That meets my objection then, your Honor.

MR. BUCK: Now the next deposition is that of T. O. Edwards:

"TESTIMONY OF T. O. EDWARDS:

"DIRECT-EXAMINATION BY G. V. SHOUP:

66 **"I** reside in Berkeley, California. My place of business is Flood Building, San Francisco. I am auditor of the Central Pacific Railway Company and have held that position since February 1, 1913. Prior to that time I was Auditor of the Missouri, Kansas & Texas Railway Company at St. Louis, just immediately prior. Prior to that time I was auditor of freight accounts for the Southern Pacific Company at San Francisco. I have been engaged in auditing work for railroad companies since February, 1886. Since that date my work has been

Testimony of T. O. Edwards—Direct.

continuous in connection with auditing work of railroad companies in one capacity or another. 67

"Statements have been prepared under my direction showing the income of the Central Pacific Railway Company for the fiscal year ending June 30, 1910, to June 30, 1914, both inclusive. I have in my hand a statement of income for the fiscal years ended June 30, 1910, to June 30, 1914, both inclusive, appearing on sheet 1, and a statement of profit and loss for the fiscal year ended June 30, 1910, to June 30, 1914, both inclusive, appearing on sheet 2, showing credits, and a statement of profit and loss for the fiscal years ended June 30, 1910, to June 30, 1914, both inclusive, showing debits appearing on sheet 3. This statement was prepared under my instructions. I have examined it. The statement was compiled from the corporate books of the Central Pacific Railway Company, consisting principally of the journal and ledger. 68

"Q. What is the procedure by which these various entries get upon the journal and ledger of the Central Pacific Railway Company?"

MR. MATTHEWS: Objected to on the ground that it is incompetent, irrelevant and immaterial and has nothing whatever to do with the issue in this case. 69

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

"A. The exact detail of the procedure I am not prepared to answer. In a general way I know the entries reach the corporate books through various sources—from statements of leasehold settlements and incidental charges and credits from different departments of the auditor's office at San

Testimony of T. O. Edwards—Direct.

70 **Francisco—from the disbursement department and from the treasury department.**

"These statements are furnished to the office of C. P. Lincoln, who is in charge of the corporate books of the Central Pacific Railway Company. When they reach Mr. Lincoln's office, they are then recorded on the books of the company."

MR. MATTHEWS: The same objection applies to all this line of testimony, and I move to strike out the answers to the preceding questions, subsequent to my former objections.

71 **THE COURT:** Motion denied.

MR. MATTHEWS: Exception.

"Q. State if you can what the surplus was as per ledger, upon the books of the Central Pacific Railway Company as of June 30, 1909?"

MR. MATTHEWS: Objected to as incompetent, irrelevant and immaterial, as not the best evidence and an improper way to prove the figures.

72 **MR. BUCK:** I may say, your Honor, that we propose to make proof and will show net surplus of each year and the dividends for each year.

THE COURT: This is in explanation of your method of proof?

MR. BUCK: Yes, sir. I am going to show the net earnings, or more technically speaking, the net surplus of five years and show that the dividends exceeded the net surplus, and, therefore, that these extraordinary dividends must have been paid out of the surplus

Testimony of T. O. Edwards—Direct.

that existed prior to that time. I am not seeking by this proof to show what that actual surplus was. 73

MR. MATTHEWS: I object, because the surplus on hand June 30, 1909, has no relation whatever to any of the issues in the case. It is not the day the excise law was passed or took effect, nor the day that the income tax law took effect.

THE COURT: I suppose that is not why this date is mentioned?

MR. BUCK: Yes.

THE COURT: The objection is overruled. 74

MR. MATTHEWS: Exception.

THE COURT: I will entertain a motion later on to strike all this out.

MR. MATTHEWS: Yes.

"A. \$25,250,361.91.

"Q. From what items is that made up?"

MR. MATTHEWS: I object to all this line of testimony, on all the grounds heretofore stated, but in order to save time and not encumber the record I will make a general objection now with the understanding that the same objection will apply to all this line of testimony with the same force and effect as if each question had been objected to and motion made to strike out each answer. 75

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

You will observe there that Mr. Shoup, when taking the deposition, stated that that was satisfactory.

THE COURT: Yes.

Testimony of T. O. Edwards—Direct.

76 **"A. Profit and loss account, \$22,752,449.12; profits from sales of lands covered by 3½% mortgage account \$1,972,621.05; sinking fund contributions and earnings account \$525,291.74. The total gross income during the year ending June 30, 1910 was \$35,948,938.87. The total debits in that period were \$29,042,226.99."**

77 **MR. MATTHEWS: Objected to and I move to strike out the answer on all grounds heretofore mentioned, and on the further ground that the items included in this total are not shown to be proper items, nor is it shown that they are allowable under corporation tax or income tax law.**

THE COURT: The objection is overruled and the motion to strike out denied.

MR. MATTHEWS: Exception.

78 **"The total credits to profit and loss during this same period were \$468,497.23. The total deficit during that period was \$35,434.82. The net credit to surplus during that year was \$7,399,774.29. The following disposition was made in the way of dividends: Dividends of 6 per cent. on common stock, \$4,036,530.00; Dividend of 2% Preferred stock, \$556,000.00. There are debits aggregating \$2,747,244.29. The surplus for the year ending June 30, 1910, was \$27,997,606.20."**

MR. MATTHEWS: I think, perhaps, your Honor, I don't know whether you or the jury can grasp all these figures, these amounts; I think we could save time by offering them in evidence and take it up later, if necessary, to explain the exhibits, if the exhibits are ultimately received.

Testimony of T. O. Edwards—Direct.

THE COURT: Well, I can only pass on these 79
questions as they come up, you know.

MR. BUCK: I don't see how your Honor can
do it any differently.

THE COURT: Do I understand that you con-
test those figures?

MR. MATTHEWS: Some of them, yes. They
put in several items here that I do not think
are proper deductions from income.

THE COURT: Suppose you do contest them,
would it not be much better——

MR. MATTHEWS: Well, I think the Court will
have to practically decide the question; I think 80
there will be some conflict as to the accounting
theory. I do not know to what extent that
will be the case until I see what stand Mr.
Buck is going to take.

MR. BUCK: Even conceding everything on
the other side, there will be so little left, so
little money left to the Southern Pacific dur-
ing those five years——

MR. MATTHEWS: Well, I am willing to ex-
cuse the jury until we get down to some real
issue.

THE COURT: No, I don't think we can do
that. 81

MR. BUCK: I am not willing, no; I want to
get this question settled once and for all by
the highest Court, and I am willing to waive
a jury as provided by statute, but unless this
is done I think it would prevent having the
construction of the Act settled by the Supreme
Court when Mr. Matthews appeals, and I don't
want to take that chance.

Testimony of T. O. Edwards—Direct.

83 **MR. MATTHEWS:** I see that Mr. Buck wants me to appeal.

THE COURT: Very well. I think we had better go on in the ordinary way, then.

MR. BUCK: Yes. I will now continue reading the deposition:

 “The total credit to income during the year ending June 30, 1911, was \$33,584,651.32. The total debits during that period were \$27,846,410.76. The total credits to profit and loss during that period were \$1,269,917.42. The total debits were \$4,643,763.80. The net credit
83 to surplus during that year was \$2,364,394.18. Dividends were paid during that year as follows: 6% on common stock, \$4,036,530; 4% extra on common stock, \$2,691,020; 2% on preferred stock, \$684,000—a total of \$7,411,550. The dividends thus paid were in excess of the surplus for that year, \$5,047,155.82. The surplus for the year ending June 30, 1911, was \$22,950,450.38. The total credits to income during the year ending June 30, 1912, were \$34,197,154.42. The total debits were \$29,455,593.82. The total credits to profit and loss during that period were \$2,695,232.89. The total
84 debits \$1,615,962.37. The net credit to surplus during that year was \$5,820,831.12. Dividends were paid during this year as follows: 6 per cent. on common stock, \$4,036,530; 2 per cent. on preferred stock, \$692,000—total of \$4,728,530. A balance of \$1,092,301.12 was added to surplus during that year. The surplus for the year ending June 30, 1912, was \$24,042,751.50. The total credits to income during year ending June 30, 1913,

Testimony of T. O. Edwards—Direct.

were \$36,831,989.92. The total debits during that period were \$32,414,788.08." 85

MR. MATTHEWS: At this point, your Honor, I want to make a further objection to all this line of testimony and motion to strike it out on the ground that the items going to make up the amount named are not shown to be proper deductions from gross income, or deductions which should be allowed either under the corporation tax act or the income tax law, calculating net income of either the Central Pacific Railway Company or the Southern Pacific Company. This is in addition to the objections heretofore made to all of this line of testimony. 86

MR. BUCK: The company is compelled to keep books only in one way, and that is as required by the act regulating commerce—the way the Interstate Commerce Commission orders them kept. We, therefore, prove income as shown by our method of bookkeeping, which is prescribed by the Interstate Commerce Commission; and I will later on introduce in evidence, in view of Mr. Matthews's objection, a statement based on this statement showing what the income is when made up in accordance with the Treasury Department's regulations. 87

THE COURT: And that forms this?

MR. BUCK: It is more in our favor, it is rather in our favor, in favor of the railroad company.

THE COURT: Yes. Objection overruled.

MR. MATTHEWS: Exception.

Testimony of T. O. Edwards—Direct.

88 "The total credits to profit and loss during this period was \$1,636,525.54. The total debits were \$473,485.52."

MR. MATTHEWS: The same objections here as the objection made to the question respecting debits to income is included in this objection, and is made to all this line of testimony.

THE COURT: Yes.

"The net credit to surplus during that year was \$5,580,241.86. Dividends were paid during that period as follows: Six per cent. on common stock,
89 \$4,036,530; three dividends of 2 per cent. each on preferred stock, \$1,044,000; a special dividend to bring dividend on preferred stock up to 6 per cent., same as on common stock, \$2,460,000—total, \$7,540,530.

"The dividends thus paid exceed the surplus of that year in the amount of \$1,960,288.14. The surplus on June 30, 1913, was \$22,082,463.36. The total credits to income for year ending June 30, 1914, were \$34,811,177.53. The total debits during that period were \$32,150,753.16. The total credits to profit and loss during that period were \$5,527,704.62. The total debits were \$5,420,833.19.
90

"The net credit to surplus during that year was \$2,767,295.80. Dividends were paid during that year as follows: On common stock, account sale of Rockaway Beach property, \$408,373; 20% special on common stock, \$13,455,100; 6% on common stock, \$4,036,530; two dividends of 3% each on preferred stock, \$1,044,000; on preferred stock, account of sale of Rockaway Beach property, \$105,627; 20% special on preferred stock, \$3,480,000. Total,

Testimony of T. O. Edwards—Direct.

\$22,529,630. These dividends exceeded the surplus 91
of that year in the amount of \$19,762,334.20. The
surplus for the year ending June 30, 1914, was
\$2,320,129.16."

MR. MATTHEWS: It is understood that my
objections apply to all this testimony, and it is
understood that they may be considered to have
been made in detail to each question on the
grounds heretofore stated, with motion to
strike out the answers, and that I reserve ex-
ceptions to the Court's rulings.

THE COURT: Yes, sir.

"The figures which I have given in my testimony 92
are taken from the sheets 1, 2 and 3, showing the
statement of income for the fiscal years ending June
30, 1910, to June 30, 1914, both inclusive, and the
statement of credits to profit and loss for the same
period on page 2, and the debits under statement of
profit and loss for the same period on page 3."

MR. BUCK: I ask that this statement be
marked for identification Plaintiff's Exhibit G
—I mean sheets 1, 2 and 3.

THE COURT: Yes.

"The figures that I have given here have been 93
taken from Exhibit G, except in respect to the fig-
ures showing payments in excess of surplus. Those
are the deductions which result from computation.
From my experience in the accounting depart-
ments of the railroad business I am able to state
the results as shown by the compilations contained
in Exhibit G.

"Q. Is this statement, which has been prepared
under your direction and which you have used as

Testimony of T. O. Edwards—Direct.

- 94 a summary in showing the results of the figures in Exhibit G, a correct statement of such results of such figures?

"A. It is."

MR. MATTHEWS: Objected to and move to strike out the answer on the ground that the figures speak for themselves.

THE COURT: Read that question again.

Question reread by stenographer.

"A. It is."

- 95 THE COURT: These are figures taken from the books, I suppose?

MR. BUCK: Exhibit G is an exact copy of the items, and then we introduce the statement which is a condensed summary of that, which shows in more condensed form just what the surplus of each year was and the dividends, and the net debit or credit.

THE COURT: That is in line with the rest of the testimony, is it not?

MR. MATTHEWS: Except this, that accountants might differ as to the result of these books or these figures.

- 96 THE COURT: Well, he is testifying to the result of calculations.

MR. BUCK: You might differ as to how you keep your accounts——

MR. MATTHEWS: We might differ as to the result they have shown on this exhibit.

THE COURT: You mean as to calculations?

MR. MATTHEWS: No. As to the amount of these figures whether, for instance, a certain

Testimony of T. O. Edwards—Direct.

item is an earning item and not a surplus item, 97
and whether it is used to pay dividends or not.

THE COURT: Objection overruled.

MR. MATHEWS: Exception.

MR. BUCK: I ask that the statement to which the witness referred as a summary showing the results of the figures in Exhibit G be marked for identification Plaintiff's Exhibit H.

THE COURT: Yes.

"The first item in the statement in Exhibit H, June 30, 1909, By surplus, \$25,250,361.91, appears as first item, sheet 2 of Exhibit G. The memorandum prepared by the Central Pacific Railway Com- 98
pany and giving the surplus for the year ending June 30, 1910, after paying dividends, and a deficit after paying dividends, and so on, for the years 1910, 1911, 1912, 1913 and 1914 was prepared under my direction. It is cumulative summary of the results for the years mentioned without regard to the surplus brought over from the year ended June 30, 1909, showing what the results would have been had there been no surplus brought into this deficit. In other words, if there had been no surplus on June 30, 1909, the deficit would have been \$22,930,232.75." 99

MR. MATHEWS: Of course it is understood that my former objections apply to all these questions and motion considered to have been made to strike out all these answers.

THE COURT: Objection overruled.

MR. MATHEWS: Exception.

MR. BUCK: I ask that this statement be marked for identification Plaintiff's Exhibit I.

THE COURT: Yes.

Testimony of T. O. Edwards—Cross.

100 "It is the custom of an accountant to mark deficits in red ink. In accounting, the red ink means a decrease or deficit. And black ink means an increase or surplus. We ordinarily have no other colors in our business."

101 MR. MATTHEWS: I will now read the cross-examination of Mr. Edwards, and I also wish to reiterate now, as I did at the time of the cross-examination of Mr. Edwards, that, by cross-examining him, that it was understood that I did not waive any of the objections heretofore taken to his testimony, and your Honor will observe that Mr. Shoup, who was representing the other side at the time, said, "That is agreeable."

THE COURT: Yes, but I do not think you waived anything by cross-examining him.

MR. MATTHEWS: All right. I will now read the cross-examination:

"CROSS-EXAMINATION OF MR. T. O. EDWARDS BY MR. MATTHEWS:

102 "I did not prepare Exhibit G personally. I just stated Exhibit G was prepared under my instructions. I cannot testify of my own knowledge as to the correctness of the figures, calculations, extensions, etc., in Exhibit G. I examined it merely as to form and did not verify the correctness of it. In giving my direct testimony, I gave a great many figures, surplus, gross-income, total debits, etc. I did not give these figures from memory, but used a copy of a statement which I believe you have on file as Exhibit H, a carbon copy, I should say. Exhibit H was prepared under my instructions.

Testimony of T. O. Edwards—Cross.

My testimony is based entirely upon the figures in Exhibit H. If the figures in Exhibit H are incorrect, then my testimony would be incorrect. I would not say that it would be misleading. My testimony, referring to figures, is based upon figures in Exhibits G, H and I. 103

"Q. A credit on the books of the Southern Pacific Company to the account of the Central Pacific Company is treated by the Southern Pacific, to all intents and purposes, as an actual receipt in cash, is it not?

"A. An open account is maintained between the Southern Pacific and the Central Pacific through which transactions involving cash due to and from the Central Pacific passes. 104

"Q. And each of these entries is the same as the actual passage of cash, that is, instead of actually passing cash, they charge it up on the books?

"A. Instead of actually passing cash the transactions are booked either debit or credit in this open account, but they pass through the cash books of the respective companies as cash transactions, with exception of leasehold settlements which are handled as direct debits or credits in open account.

"MR. MATTHEWS: That is all I have to ask." 105

MR. BUCK: I will now read the redirect-examination:

"MR. SHOUP:

"Exhibit H was prepared by Mr. Lincoln, as well as Exhibit G. I made a brief comparison of the figures in Exhibit H with Exhibit G, sufficient, as I thought, to determine the accuracy of the compila-

Testimony of T. O. Edwards—Cross.

106 tion of Exhibit H. I examined Exhibit H sufficiently to convince myself that Exhibit H was a correct summary of Exhibit G; and the same is also true of Exhibit I.

107 "Under the terms of the lease between the Central Pacific and the Southern Pacific Companies, the Southern Pacific operates the railroads of the Central Pacific and applies the earnings and income to all operating expenses, including the sums payable for rental of these lines, and payments of current interest and sinking fund contributions and other payments, as from time to time may become due to the United States or bondholders during the existence of the lease. Now assuming that certain payments, as for instance, interest due upon bonds are paid by the Southern Pacific Company on behalf of the Central Pacific, the Central Pacific books that payment in its accounts just as though it paid the money directly itself, except that instead of crediting cash Southern Pacific Company is credited. The Southern Pacific makes a report to the Central Pacific of all payments, for interest or other debts, and charges the Central Pacific with the amount thereof, and the Central Pacific correspondingly credits the
108 Southern Pacific Company.

"Q. What does the Southern Pacific do with any cash surplus that may become due to the Central Pacific from year to year? Does it retain it in its own possession, giving the Central Pacific credit therefor, or does it pay it over to the Central Pacific?"

MR. MATTHEWS: I object to all of this on the same grounds heretofore stated, according to the stipulation entered into.

Testimony of John P. Duffy—Direct.

THE COURT: Objection overruled.

109

MR. MATTHEWS: Exception.

"A. It retains the cash in its own possession, but credits the Central Pacific with the amount thereof on its books, and the Central Pacific correspondingly charges Southern Pacific on its books.

"When a dividend is declared payable to the Southern Pacific as a stockholder of the Central Pacific, any indebtedness due from the Southern Pacific to the Central Pacific on account of such cash surplus is liquidated in that manner to the extent of the dividend."

MR. BUCK: I will next read the deposition of Mr. John P. Duffy: 110

"TESTIMONY OF JOHN P. DUFFY.

"DIRECT-EXAMINATION BY G. V. SHOUP:

"My name is John P. Duffy. I reside at 920 Palm Avenue, San Mateo, San Mateo County, California. My place of business is 633 Market street, San Francisco. I am an employee of the Southern Pacific at this time, traveling passenger agent. I was previously an employee of the Central Pacific Railway Company. I was employed by the Central Pacific as bookkeeper, shortly after the organization of the Central Pacific Railway Company, I should judge in 1900, and that employment continued until March 31, 1913. Mr. Thompson preceded me in my employment as bookkeeper for the Central Pacific Railway Company. The last I heard of him, he had moved to Washington, D. C. No one preceded Mr. Thompson. He was the original man on the books at that time. Mr. Folsom was in the employ of the

111

Testimony of John P. Duffy—Direct.

112 Central Pacific the same as I was. He was accountant and I was bookkeeper. As bookkeeper I entered all of the transactions that were received in our office, or which came to our office through the treasury office, the assistant auditor's office, Land Department, the auditor's office and the New York office. I had the following books for these entries: A cash book, journal and ledger, and other small detail books but those were the principal books. The items in connection with the income of the Central Pacific Railway Company were entered in the journal and ledger and cash book. I did not make all of the entries in the journal and ledger during that
113 period that I have mentioned as the period of my employment. Mr. Folsom, Mr. Lincoln and myself made them. Mr. Folsom is deceased. Mr. Lincoln is still in the employ of the company. The reports received from the New York office consisted of different items that appear, such as interest on securities allowed by the different trust companies, and at the end of the year the leasehold operations for the year. These reports were entered by me in the cash book, journal and ledger currently and posted daily as we received them."

114 MR. MATTHEWS: I object to all of the questions that have been asked and move to strike out the answers on the grounds that it is incompetent, irrelevant and immaterial, and that the testimony has no bearing whatever on the issues involved in this case, and the same objections will apply without being repeated, to each of the questions and answers along the same line that may follow.

Testimony of John P. Duffy—Cross.

"We would receive on the average during the 115
month from these different sources that I have
mentioned between eighty and one hundred re-
ports, possible more. I have myself checked the
statement marked for identification Plaintiff's Ex-
hibit G, with the entries upon the books of the
Central Pacific Railway Company, namely, the
journal and the ledger, sufficiently to enable me
to say that that statement contains correct entries
for the period mentioned. It contains correct
copies of those entries. Mr. Lincoln has the su-
pervision and control of the accounts of the Cen-
tral Pacific Railway Company here. Mr. Lincoln
reports to the Assistant Auditor, and then to the 116
Auditor, Mr. Edwards."

MR. MATTHEWS: I will now read the cross-
examination, and I will also read my state-
ment which I made at that time, and which I
wish to repeat here:

"CROSS-EXAMINATION BY MR. MATTHEWS:

"MR. MATTHEWS: By cross-examining this
witness, may it be understood that I do not
waive any of the objections heretofore taken
to his testimony. 117

"MR. SHOUP: That is agreeable."

MR. MATTHEWS: If your Honor please, I
wish to move to strike out the testimony
of each witness, or may I make that motion
at the end of the testimony?

THE COURT: You had better wait until all
the testimony is in.

MR. MATTHEWS: I just want to make cer-

Testimony of John P. Duffy—Cross.

118 tain of the record, that it shows I have all along preserved the question.

THE COURT: I think you have done that very well, Mr. Matthews.

MR. MATTHEWS: All right, then. Now I will go ahead and read the cross-examination:

119 “Since March 31, 1913, I have had nothing whatever to do with the books or bookkeeping of the Central Pacific Railway Company. From the 1st of January, 1909, down to the time I left I was bookkeeper under Mr. Lincoln and my duties were to keep the books of the Central Pacific Railway Company and other companies as well, and whatever came up in the way of bookkeeping. I kept the Central Pacific Railway Company's books. I was employed by both the Southern Pacific Railroad Company and the Central Pacific Railway Company during that period. At the end of the year the salary was divided—50, 25 and 25. Each company paid in their *pro rata* share of its salary, depending upon the amount of work done for each one. That was true of other employees at the same time. I stated that my duties were to enter into the journal, cash book and ledger
120 certain figures that came to my office—I mentioned the New York office, the treasurer's office and the different auditors' offices; also the land department. My office was located, during the period from January 1, 1909, to March 31, 1913, in the Flood Building, San Francisco. All those books were kept there. Those books are now located in this same building as far as I know.

“Q. Did you know anything about the accuracy

Testimony of John P. Duffy—Cross

of the records or did you just enter them without 121
verification?

"A. They are all verified by Mr. Lincoln or myself. For instance, interest on the different securities that we had, we checked them all up with our ledger account to see if they agreed. The same with the different bonds. We verified the footings, extensions and all that. For instance, the land accounts report—they came up at the end of the month. These were checked over, extensions carried out, entered in the journal. Reports from the treasurer's office were checked out—checked for footings and extensions. Either 122
Mr. Lincoln or I went into the actual transaction that the report represented if necessity warranted it. We knew just what the account referred to. We checked it up and saw if it was correct before we entered it on the books. It was not possible to do that in all cases. In a great many cases it was impossible to verify reports from our books, say of land, for instance. Well, if we were in doubt we would go out and check it up in the land department, but oftentime, for instance, from the New York office, it was impossible to check. Those were checked for extensions and footings. Referring to Exhibit G for identification, I have 123
checked this over and found it to be accurate. I went over all of the figures, and checked it personally, enough to satisfy myself it was correct. It took me a couple of hours yesterday. My statement that it is correct is based upon my confidence in the action of the man who prepared it more than in the absolute figures themselves. I can not swear that every figure in this is correct, but I am

Testimony of E. T. Johnson—Direct.

124 satisfied it is correct, but I would not swear to it. The balances check out, I know. I went into, for instance, the details of the debit items on Sheet 3 just to check it over. I did not go into each item to see if it was correct; but I am satisfied it is correct. Of course, I do not know anything about the books after the 31st of March, 1913. All of my testimony is based on the transactions prior to that time. I did not testify to anything subsequent to that date."

MR. BUCK: I will now read the remainder of this deposition:

125 "These reports upon which entry is made by me, are entered as they were received, in the regular course of business. In the ordinary routine, and as I received them they were entered upon the books."

MR. BUCK: I will now read the testimony of E. T. Johnson:

"TESTIMONY OF E. T. JOHNSON:

"DIRECT-EXAMINATION BY G. V. SHOUP:

126 "My full name is Emil T. Johnson. I reside at 1612 Sonoma Avenue, Berkeley, Alameda County, California. My place of business is the Flood Building, San Francisco. I am an employee of the Central Pacific Railway Company. The nature of my employment with that railway company is as Bookkeeper. I have held that position since April 1, 1913, to date. I am still an employee. I succeeded Mr. J. P. Duffy, the gentleman who has just testified. As bookkeeper for the Central Pacific Railway Company, I made the entries from the re-

Testimony of E. T. Johnson—Direct.

ports received from the New York Office, Miscellaneous Accounts, Assistant Auditor's Office, Assistant Treasurer's Office and the Land Department. I make those entries in the Journal, cash book and ledger." 127

MR. MATTHEWS: I object to the questions and answers, of this witness on the ground that they are irrelevant, incompetent and immaterial and have no bearing whatever on the issues in this case. These objections may be deemed to be made to each and all of the questions that may hereafter be propounded, and motion made to strike out the answers. 128

"These entries were made by me from these reports, as they were received.

"Q. About, on an average, how many reports did you receive per month from these different sources?"

MR. MATTHEWS: I make the same objections, if your Honor please.

THE COURT: Yes. Objection overruled.

MR. MATTHEWS: Exception.

"A. About one hundred. I have examined the statement of accounts that has been referred to for identification as Plaintiff's Exhibit G myself. I have made a comparison of that statement with the ledger and journal of the Central Pacific Railway Company. From such examination and comparison I can say that such statement is a correct copy of the entries appearing on those books. There are about 12 employees in the Assistant Treasurer's Office who handle the reports which come from that office. About 30 employees are engaged in 129

Testimony of E. T. Johnson—Direct.

180 making up the reports which come to me from the Miscellaneous Accounts. About 25 employees are engaged in the handling of those reports which come to me from the Land Accounts Department.

“Q. Are there departments other than those you have mentioned here, in this building, which make reports to you, or reports from which come to your office?”

MR. MATTHEWS: I make the same objections.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

181 “A. Not directly, but indirectly there are. The Disbursements, Freight and Passenger and Equipment Service offices make reports and pass them to the Miscellaneous Accounts, and from the latter source they are received by us. There are 700 employees, approximately. I am not familiar with the personnel of the New York office. I cannot say how many persons are engaged in handling the reports which come to me from that office. The New York office gets its data, on which it bases its report to the Central Pacific, from various sources, such as the Trustees of the Railway Company’s mortgages, the public, etc. There are reports from the Auditor’s office of San Francisco
182 which go back to the New York office. The reports which they make are based upon reports which are received from the office here. I make the entry first, in most cases, and check against the New York office. I do not know how many employees are under the jurisdiction and control of Mr. Edwards as Auditor of both the Southern Pacific and Central Pacific Companies here in San Francisco.”

MR. MATTHEWS: I now wish to state again by cross-examining the witness, may it be

Testimony of E. T. Johnson—Cross.

understood that I do not waive any of the 183
objections heretofore taken to his testimony.

I will now read the cross-examination.

"CROSS-EXAMINATION BY MR. MATTHEWS:

"I spent about a day in examining Plaintiff's Exhibit G for identification. I did not prepare it myself. I checked against entries made in the journal and ledger and verified the balances against the ledger balances for each fiscal year.

"From that examination I would say that every figure in this Exhibit G for identification, is correct, as shown in the journal and ledger. I have taken the figures and entries there as correct. If 184
there had been any mistake on the ledger or journal, that mistake would have been reflected here. I did not go back of the journal and ledger in verifying them.

"Mr. C. P. Lincoln directed the method of entries of the various items in the journal and ledger. The charges made against profit and loss and carried into surplus, all have been directed by him. I testify here as the bookkeeper for the Central Pacific Railway Company. I am also employed by the Southern Pacific Railroad Company—not employed by the Southern Pacific Company. My salary is paid in part by the Southern Pacific Railroad 185
Company, and in part by the Central Pacific Railway Company. The two companies are separate and distinct corporations. I do not know anything about the accounts of the Southern Pacific Company. I have nothing to do with their books. Their records are kept entirely separate and distinct from the Central Pacific Railway Company and the South-

Testimony of E. T. Johnson—Redirect.

136 ern Pacific Railroad Company. All of their records and books are kept entirely separate as though they were corporations with no relation whatever between them. Aproximately 100 reports came to me monthly from various sources. I verified them as to extensions or footings, and against any other record, if any, kept in our office. There are a great many reports that cannot be verified by our records, other than for the extensions and footings. With reference to the prices paid for sale of lands, we received from our Land Department an approved appraisal list showing description of lands sold or
137 for sale with the prices, showing opposite each parcel of land. This appraisal list is referred to in checking entry made in our 'Record of Contracts' book and also in checking land contracts and deeds sent to our office. The reports of the earnings of the company are furnished us by the Miscellaneous Accounts Department. As a rule we can only check that as to the footings. We do not handle the cash too. No bank accounts at all."

MR. BUCK: I will now continue the redirect-examination:

138 "The cash transactions are covered in the reports which I get from the Treasurer's office. As to the earnings of the Southern Pacific Company, on freight and passenger, for instance, I get reports from the Miscellaneous Accounts each month, and then at the end of the year we get a report from the New York office, showing all expenses and revenues. I have no way of verifying those reports as to freight and passenger."

Testimony of E. T. Johnson—Recross.

MR. MATTHEWS: I will now read the recross- 129
examination.

"MR. MATTHEWS: By cross-examining this witness, may it be understood that I do not waive any of the objections heretofore taken to his testimony.

"Exhibit G is a copy of certain debits and credits shown on the books. I could not say that the books would not show any additional figures, but the balances would be the same.

"Q. Does this Exhibit show only balances?

"A. Well, I would not be positive. The balances shown agree with the ledger balances. The Ex- 140
hibit includes all the balances shown on the books.

"Q. It includes none of the detailed figures?

"A. No; that is, there may be some in the journal that would not be here. Can I correct my previous answer? It is substantially a copy of the journal and the ledger.

"Q. Which is it now; it just agrees with the balances or is a complete copy of the books?

"A. Well, I could not say word for word, but the figures agree with the books, the journal and ledger. Take, for instance, the next to the last item under the credits on Sheet 1, Income from 141
Miscellaneous Physical Properties for 1914, \$17,101.67. That agrees exactly with the journal. The ledger account would not show the detail. The journal would. The journal would not show in more detail than is shown here, but the same detail. The name of the account and the amount would agree with the journal. The item \$17,101.67 appears as a single item in the journal. That item is not made up of sub-items that appear in the jour-

Testimony of E. T. Johnson—Recross.

142 nal. It appears just as it is in the journal. The journal does not have the income from Miscellaneous Physical Properties itemized, but just the name of the account. I know nothing about that item other than that the figures appear in the journal and ledger. I do not know about the entries back of the journal. Take the first item on that sheet, 'Rentals for Joint Tracks, Yards, etc.', it appears in the journal just that way. No more detail than is stated there. That is true of all the items. To each and every one of the questions asked me about the two items specifically mentioned, I would answer the same as to all the other

143 items on Exhibit G. That applies to each item on the first sheet. And to each and every item on the second sheet. I could not say as to the exact wording, but the amounts would be the same as the journal. And the substance of the wording would be practically the same. That applies to each and every item on sheet 2. I did not go back of any of those figures. I did not know anything about the details going to make them up. Kindly change my preceding answer. I do know something of the detail which goes to make up some of them, for instance, Proceeds from Sale of Lands, we have

144 the detail on that. I did not go into the details in checking the statement over; just simply the balances. I compared the statement with the journal and ledger. Also this account Sinking Fund Contributions and Earnings; the detail is down in our office. Do you want me to go over each and every one to ascertain if the detail is made up in our office?

"Q. I do not. I do not think it is necessary. All

Testimony of E. T. Johnson—Recross.

I want to bring out is the fact that this statement 145
is merely based on the balances shown in the journal and shows no details of the account and none of the details are shown in the books.

"A. It is not a fact that this is based purely on the journal and not based on any detailed figures. We have details of certain of these, but the details were not gone into in making this up. The detail was made up prior to this statement. As to Sheet 3 of Exhibit G, the same thing applies to items there as to the other items referred to on Sheets 1 and 2. My office handles no cash. We have a cash book, but we do not handle cash; that is done through the Treasurer's office. We do not have any bank account or bank books. The Southern Pacific Company pays a great many of the accounts of the Central Pacific, and charges such payments against the Central Pacific. And when it receives moneys on account of Central Pacific, it credits the Central Pacific with these moneys. The Central Pacific bookkeeper and Auditor or Accountant considers that it receives money as of the date it is credited. It takes it up on its books as received when it is credited to the Central Pacific by the Southern Pacific. In other words, if the Southern Pacific should credit the Central Pacific Company with an item, the Central Pacific would consider that as received on the date that credit was entered. There is no other way in which the Central Pacific Company receives money than by credit on the books of the Southern Pacific. The Assistant Treasurer's receipts and disbursements for the Central Pacific Railway Company's account do not go into the Southern Pacific Company's account daily; that is, he reports the 146 147

Testimony of C. P. Lincoln—Direct.

- 148 cash from day to day, and they, the receipts and disbursements, go direct to the Central Pacific cash book. At the end of the month it passes through Miscellaneous Accounts and they in turn transfer the balance to the New York office, and in that way it goes on to the Southern Pacific Company's books in New York."

MR. BUCK: I will now read the deposition of C. P. Lincoln:

"TESTIMONY OF C. P. LINCOLN.

- 149 "DIRECT-EXAMINATION BY MR. G. V. SHOUP:

"My name in full is Charles Percival Lincoln. I reside at 3015 Hillegass Avenue, Berkeley, California. My place of business is Flood Building, San Francisco. I am an accountant employed by the Central Pacific Railway Company. I have no official title. My position is known as the head clerk of the corporate accounts bureau of the Auditor's office. I have been connected as accountant with the Central Pacific Railway Company since 1901. As head clerk of the corporate account bureau I am in charge of the corporate books and records of the various lessor companies. I have charge of such books and records of the Southern Pacific Railroad Company also. I have held that position as head clerk of the Central Pacific Railway Company since 1910. Before that time I was assistant secretary of a number of companies and located in the office of the secretary of those companies. I was connected with the Central Pacific Railway Company prior to 1910. I was accountant in the office of the secretary of the Cen-

150

Testimony of C. P. Lincoln—Direct.

tral Pacific Railway Company. Mr. J. L. Willcutt had charge of the corporate books of the Central Pacific Railway Company at that time. They were kept in the secretary's office. They were transferred or removed from the secretary's office about the 1st of May, 1910, to the Accounting Department of the Southern Pacific Company. They were not in the accounting department before 1910. The procedure relative to the entries that are made in the cash book, ledger and journal of the Central Pacific Railway Company is as follows: We receive statements on which entries are based from four or five different sources, namely, from the New York office, from the Auditor of Disbursements, from the Miscellaneous Accounts Bureau of the Auditor's office and from the Assistant Treasurer's office, San Francisco; some entries are based on statements that we work up in the corporate accounts bureau from our land accounts. I think that will cover the different sources. I do not make these entries myself in the cash book, ledger and journal. They are made up by some one else at present. At the present time Mr. E. T. Johnson makes these entries. Mr. J. P. Duffy journalized all the entries shown here, between July 1, 1909, and up to about March, 1913. I personally posted those entries I think, for about the first six months of 1910. After March, 1913, Mr. E. T. Johnson journalized the entries and posted them. During the time that I did not post them—prior to Mr. Johnson, Mr. John P. Duffy posted the entries. Those books—the cash book, journal and ledger, contained all corporate accounts of the Central Pacific Railway Company as final entry.

Testimony of C. P. Lincoln—Direct.

- 154 I have prepared a statement taken from the journal and ledger showing the entries therein during the period of June 30, 1910, to June 30, 1914. I prepared the statement marked for identification Plaintiff's Exhibit G. I first referred to the income and profit and loss accounts in the ledger, and then to the journal for the journal entries posted therein, and made this statement from the journal entries. The items that appear upon this statement upon sheets 1, 2 and 3 are correct copies of the entries as they appear in the journal. I made the copies myself. The items contained in
- 155 this statement, upon these three sheets, were obtained from the corporate books of the Central Pacific Railway Company—the ledger, journal and cash book. These items were in the journal and ledger. All the items in the cash book did not go into the journal and into the ledger. Entries are posted direct from the cash book to the ledger, but those entries I obtained from the journal and the ledger, because they were the only ones affecting the income and profit and loss. I obtained all of this information from those two books. There is nothing in the cash book that does not appear either in the journal or ledger. In making up this
- 156 statement I omitted no item from the journal or ledger. The journal and ledger books are in the Auditor's custody—the Auditor of the Southern Pacific Company, and also of the Central Pacific Railway Company. I have immediate charge of these books. This ledger and journal constitute the original books of the company. I knew them to be such at the time I made the copies therefrom. I prepared the statement marked Plaintiff's Ex-

Testimony of C. P. Lincoln—Direct.

hibit H for identification. It shows the surplus 157
June 30, 1909, and the surplus each fiscal year
thereafter up to and including June 30, 1914.
This statement is based upon the accounts which
I have copied from the journal and ledger of the
Central Pacific Railway Company and referred to
for identification as Exhibit G. It is a correct
summary of the results of the statement. I pre-
pared the other statement that has been referred
to for identification as Plaintiff's Exhibit I. That
statement is based upon the statement previously
referred to as Exhibit G. That statement cor-
rectly shows, in a summary way, the results of the 158
statement Exhibit G. I prepared the statement
showing the debits and credits to profit and loss
during the year ending June 30, 1910, to June 30,
1914, both inclusive, which cover transactions
prior to July 1, 1909. I got the items that appear
on this statement from the statement showing
debts and credits to profit and loss during that
period. This statement is a correct statement of
the debits and credits to profit and loss during the
year ending June 30, 1910, to June 30, 1914, both
inclusive, which cover transactions prior to July 1,
1909.

"Q. Why was it that although these were trans- 159
actions which occurred prior to July 1, 1909, they
are included in the statement for the period of
June 30, 1910, to June 30, 1914?"

MR. MATTHEWS: Answer objected to on the
ground that it is incompetent, irrelevant and
immaterial and nothing whatever to do with
the issues here, as it is the income of the
Southern Pacific and not with the income of

Testimony of C. P. Lincoln—Direct.

160 the Central Pacific Company that we deal. Further the witness is not competent to testify in regard to the Southern Pacific's income. My objection is to be taken as applying to all the questions and answers.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

"A. Well, in a general way, they are all adjustments of transactions that occurred prior to the year ending June 30, 1910."

161 MR. MATTHEWS: The same objections will apply, if agreeable, to all this line of testimony, in addition to the other objections heretofore made.

THE COURT: Yes.

"The result of those transactions shows that during the year ending June 30, 1910, we credited \$240,064.27 to profit and loss, and that during the year ending June 30, 1911, we credited \$701,252.22; during the year ending June 30, 1912, we credited \$2,209,898.80; during the year ending June 30, 1913, we credited \$543,018.81, and debited approximately \$38,346.61; during the year ending June 30, 1914, we credited \$2,381,163.92, and debited \$3,025,240.04, making total debits of \$3,063,586.65 and total credits of \$6,075,398.02; net credits \$3,011,811.37.

162 "Q. State what the result would have been if a readjustment of these transactions had been booked currently during the period which they represent?"

MR. MATTHEWS: Objected to on the ground that the question is hypothetical and the witness is not qualified to answer and on the additional ground that it is incompetent, irrelevant

Testimony of C. P. Lincoln—Direct.

and immaterial, and also on all of the grounds heretofore interposed to the testimony of this witness. 163

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

"A. The result would have been that instead of showing a surplus of June 30, 1909, of \$25,250,361.91, it would have been \$28,262,173.28.

"MR. SHOUP: Would say that the statement to which the witness refers is marked for identification as Plaintiff's Exhibit J.

"Q. Referring to the statement marked for identification Plaintiff's Exhibit H, and particularly to the item at the top of the statement—'June 30, 1909, by surplus as per ledger \$25,250,361.91,' I got that item from the ledger and I arrived at that total by taking the 'Profit and Loss' account and 'Proceeds from the sales of land covered by 3½ per cent. mortgage', a sub-profit and loss account, and 'sinking fund, contributions and earnings', a sub-profit and loss account,—the three aggregating the \$25,250,361.91. Those accounts appear in the ledger. Referring to the resolution passed by the Central Pacific Railway Company December 23, 1913, relating to the sale of certain property comprising the westerly end of Rockaway Point, and more specifically described in Exhibit C, the sum (mentioned in this resolution) of \$514,000 was received by the Central Pacific, and entered upon its books. The dividends referred to in this resolution were paid out of the proceeds of this sale." 164 165

MR. MATTHEWS: I move to strike out all the answers to the preceding questions, on the

Testimony of C. P. Lincoln—Direct.

166 ground that they are incompetent, irrelevant and immaterial, and do not bear upon the issues in this case, and on the other grounds heretofore made to the testimony of this witness.

THE COURT: Motion denied.

MR. MATTHEWS: Exception.

167 "The surplus out of which the special dividends involved in this suit were paid, included the sale of other capital assets. The surplus included as of June 30, 1914, \$3,401,448.48, from the proceeds of sales of land covered by the 3½% mortgage. Of that amount \$3,151,770.14 had been applied to the redemption of the 3½% bonds of the Central Pacific Railway Company. There are no other capital assets that were sold which went to make up a part of this surplus.

"Q. Referring to the fifth paragraph of Article Twelve of the complaint in this case, alleging in regard to the dividend of 6% paid by the Central Pacific Railway Company on its common stock on June 14th, over and above the net earnings of the company, June 13, 1913, have you any statement showing how this computation was arrived at?"

168 MR. MATTHEWS: My objection applies to all this, particularly to this question.

THE COURT: Yes. Objection overruled.

MR. MATTHEWS: Exception.

"A. Yes. The amount is based on Form CT-1, showing the income for the calendar year 1913 amounting to \$4,896,258.79, less debits to income aggregating \$755,158.07; also CT-1 for the six months ending June 30, 1914, showing the total income for that period of \$2,536,470.73, and Form CT-2,

Testimony of C. P. Lincoln—Direct.

showing total expenses of \$338,393.09 to which is 169
added adjustments after final return had been made,
amounting to \$21,119.16, making a total income for
the period stated, namely, calendar year of 1913,
and six months ending June 30, 1914, \$6,360,297.52.
From that amount was deducted 1/2 of dividend of
6% on common stock, paid in June, 1913, \$2,018,-
265.00; 1/3 of dividend on preferred stock, paid in
February, 1913—\$116,000; 1/6 of dividend of 2%
on preferred stock June, 1913, \$58,000; and semi-
annual dividend of 3% on preferred stock paid in
August, 1913, \$522,000, and semi-annual dividend
of 3% on preferred stock, paid in February, 1914, 170
\$522,000. Total deductions, \$3,236,265, leaving an
amount included in return of annual net income for
the six months to June 30, 1914, of \$3,124,032.52.
All of the accounts of the Central Pacific Rail-
way Company are kept in accordance with the rules
and regulations of the Interstate Commerce Com-
mission.

"I personally prepared the return of the annual
net income of the Central Pacific Railway Company
for the purpose of fixing the income tax. Mr. Hol-
brook assists me in the details of that work."

MR. BUCK: The Plaintiff now offers in evi- 171
dence statement marked for identification,
Plaintiff's Exhibit G, and asks that it be made
a part of the data and records in this case, as
Plaintiff's Exhibit G. This exhibit consists of
sheets 1, 2 and 3.

MR. MATTHEWS: I object on the grounds,
first, that the exhibit offered is not the best
evidence of the facts therein purported to be
set forth, subject to Exhibit 2-I.

Testimony of C. P. Lincoln—Direct.

172

MR. BUCK: Page 1 of that exhibit shows the items that go to make up the gross income of the Company for each of the five fiscal years ending June 30, 1910 to June 30, 1914, inclusive, and also the deductions from gross income; I mean by that the operating expenses and so on, and the next page shows—sheet 2,—shows credits to surplus, and sheet 3 shows debits to surplus, and finally the net surplus for each of the five years in question prior to the payment of dividends.

173

MR. MATTHEWS I have stated my grounds of objection in the deposition, and I am reading those grounds now.

MR. BUCK: The objection to the effect that the original items in the books were not offered is waived by the stipulation (Exhibit 2-I).

THE COURT: You do not object because they are copies?

174

MR. MATTHEWS: No, that objection I have waived by the stipulation. I object to the exhibit offered as not the best evidence of the facts and that, of course, will apply if the books themselves were here and as not constituting the best evidence; and of course I have not waived that ground of objection.

Now, second, on the ground that the exhibit consists principally of conclusions; third, that the contents of the exhibit are irrelevant to the issues in this case; fourth, that it is immaterial; fifth, that the exhibit is not competent to prove the facts therein purported to be set forth and is not the proper way to prove such facts; sixth, that the exhibit as-

Testimony of C. P. Lincoln—Direct.

sumes the correctness of the entries and figures 175
and there has been no proof of the correctness
of such entries and figures; seventh, that there
has been no evidence showing the exact method
of accounting and bookkeeping used in com-
piling the books on which the statement G is
based, and the exhibit for that reason is am-
biguous and misleading, and has not been suf-
ficiently explained and interpreted.

THE COURT: There is one ground there, I
think, and the only ground that requires con-
sideration, and it is the last one, as to the
method of keeping the books. The objection is 176
overruled.

MR. MATTHEWS: Exception.

The statement marked Plaintiff's Exhibit G
was received in evidence and read to the jury
and a copy is hereto annexed and made a part
hereof.

"MR. SHOUP: Let the record show that the
plaintiff offers to let counsel for defendant or
any representative of the defendant examine
the original books from which this statement
G was compiled at any time that he may de- 177
sire for the purpose of verifying the entries
contained in this statement, and the books are
now in the custody of Mr. Lincoln, in the
building in which this deposition is being
taken."

MR. BUCK: The plaintiff now offers in evi-
dence the statement heretofore marked for

Testimony of C. P. Lincoln—Direct.

178 identification Plaintiff's Exhibit H, the statement consisting of three sheets.

That is the exhibit which was referred to before as a condensation of Plaintiff's Exhibit G, and shows the net surplus for each year and the dividends paid each year.

179 MR. MATTHEWS: I object on all the grounds heretofore stated in my objections to the statement G which may be understood as ground to be considered as though set forth with the necessary changes as required by the variations in the composition of the exhibit.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The statement marked for identification Plaintiff's Exhibit H was received in evidence and read to the jury and a copy is hereto annexed and made a part hereof.

MR. BUCK: The plaintiff now offers in evidence the statement heretofore marked for identification Plaintiff's Exhibit I. That is simply a further condensation of Exhibit H.

180 MR. MATTHEWS: Same objections, with the same stipulations.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The statement marked Plaintiff's Exhibit I was received in evidence and read to the jury and a copy is hereto annexed and made a part hereof.

Testimony of C. P. Lincoln—Direct.

MR. BUCK: The plaintiff now offers in evidence the statement heretofore marked for identification Plaintiff's Exhibit J, consisting of two sheets. 181

MR. MATTHEWS: Same objections, same stipulation.

THE COURT: Objections overruled.

MR. MATTHEWS: Exception.

The statement marked Plaintiff's Exhibit J was received in evidence and read to the Jury, and a copy is hereto annexed and made a part hereof. 182

MR. BUCK: If your Honor please, in view of Mr. Matthews' objection on behalf of the defendant, *ante*, page 29, that Exhibit G does not show proper deduction from gross income, on the ground that the items shown in Exhibit G, going to make up the amount named, are not shown to be proper deductions from gross income, or deductions which should be allowed either under the corporation tax act or the income tax law, I now wish to make proof of the income and surplus of the company under the Treasury Department's regulations; and that is the testimony I am now about to offer. 183

THE COURT: All right.

"Form CT-1 consisting of statement of income and profit and loss of the Central Pacific Railway Company for use in compiling Federal Corporation Tax 'Return of Annual Net Income' for calendar year 1913, referred to in my testimony yesterday, was prepared from a statement of the income and

Testimony of C. P. Lincoln—Direct.

- 184 profit and loss of the Central Pacific Railway Company for the year ended June 30, 1913, prepared from the books of the Company, from a similar form for the calendar year ending December 31, 1912, and from the balance sheet of the ledger for the six months ending December 31, 1913. For instance, the gross transportation income, various rentals, less operating expense, taxes, interest on funded debt—the net result of those items that I have just mentioned shows this profit from leasehold operations. I prepared this statement for the preparation of
- 185 the return of the annual net income of the Central Pacific Railway Company for the calendar year. That return is filed with the Collector of Internal Revenue. I prepared this statement from the annual income and the profit and loss which is taken from the corporate books of the company. My explanation with reference to the form marked Statement of Income and Profit and Loss of Central Railway Company for the six months ending June 30, 1914, is the same as with reference to the other one. Attached to each of these forms is a form marked Form CT-2 being headed Statement of Income and Profit and Loss of the Central
- 186 Pacific Railway Company, for use in computing Federal Corporation Tax 'Return of Annual Net Income'. My explanation as to how these forms are prepared is the same as with reference to form CT-1. I testified yesterday in reference to the method in which I had made certain computations to determine whether or not the dividend of 6% paid June 13, 1914, by Central Pacific Railway Company on its common capital stock amounting

Testimony of C. P. Lincoln—Direct.

to \$4,036,530, exceeded the net earnings of the company since January 1, 1913, available for such dividends, by \$912,497.48. The statement handed me shows those computations." 187

MR. BUCK: I offer in evidence Form CT-1 showing statement of income and profit and loss of Central Pacific Railway Company for use in compiling Federal Tax return of annual net income for calendar year 1913, being also further headed "Credit" and Form CT-2 for the same period, headed "Debit", and ask that these two forms be marked Plaintiff's Exhibit K. 188

MR. MATTHEWS: Same objections as made to Exhibit G, as if here repeated and fully set forth.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The said Forms CT-1 and CT-2 for year 1913 were received in evidence and marked Plaintiff's Exhibit K. The said Exhibit was read to the jury and a copy is hereto annexed and made a part hereof.

Mr. BUCK: I offer in evidence Form CT-1 Statement of Income and Profit and Loss of Central Pacific Railway Company, for use in compiling Federal Tax Return of Annual Net Income for six months ending June 30, 1914, being headed as "Credit", and the accompanying form CT-2, for the same period headed "Debit" and ask that it be marked Plaintiff's Exhibit L. 189

MR. MATTHEWS: Same objections as made to

63

Testimony of C. P. Lincoln—Direct

190

Exhibit G, as if here repeated and fully set forth.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The said Forms CT-1 and CT-2 for six months ending June 30, 1914, were received in evidence and marked Plaintiff's Exhibit L. The said Exhibit was read to the jury and a copy is hereto annexed and made a part hereof.

191

MR. MATTHEWS: I move to strike out these two exhibits on the ground that they are merely compilations gotten up by the Central Pacific for the purpose of making an Income Tax Statement, and the Government is not bound by their figures in this statement, or their figures on the return of their income.

THE COURT: I suppose they are taken from their books of account. I have to assume this is taken from their books.

MR. MATTHEWS: In part, it is.

192

MR. BUCK: The books are kept in accordance with the Interstate Commerce Commission's rules and regulations; and the Treasury Department, when it comes to make up income, has certain ideas different from the Interstate Commerce Commission's. The law compels us to keep our books in accordance with the Interstate Commerce Commission's regulations. In preparing our income tax return, we take off on the CT—that means corporation tax—we take off on these corporation tax forms substantially the same items that appear on Exhibit G, and we translate

Testimony of C. P. Lincoln—Direct.

them into Treasury Department taxable income in accordance with the Treasury Department's rules, and from that we finally make up our income tax return. I want to show the method by which the income tax returns were made up. 193

MR. MATTHEWS: We have the judgment there of the man who makes the form up of what the tax law means; and I think we should have the Court's judgment on that rather than of the man who makes it up.

MR. BUCK: I now offer in evidence the statement referred to by the witness as containing the methods of computation in support of the claim that the dividend of six per cent. paid June 30, 1914, by Central Pacific Railway Company on its common capital stock, amounting to \$4,036,530, exceeded the net earnings of said company since January 1, 1913, available for payment of the said dividend, by \$912,497.48, and ask that it be marked Plaintiff's Exhibit M. 194-

MR. MATTHEWS: The same objections to this as interposed to the introduction of Exhibit G, with the additional objection that the witness has not shown himself qualified to testify as to the facts purported to be shown by Exhibit M. 195

MR. BUCK: I will withdraw the Exhibit, your Honor, as it is not material.

THE COURT: All right.

"I prepared the statement handed me, Exhibit N, contained in three sheets, the first sheet of which is entitled Central Pacific Railway Company State-

Testimony of C. P. Lincoln—Direct.

196 ment of Income for fiscal year ending June 30, 1910, to June 30, 1914, both inclusive, as prepared for the return of annual net income. This statement was prepared from Forms CT-1 and CT-2 previously referred to for the period shown. These forms in turn were based upon statements that were prepared from the corporate books of the company. I prepared this statement. This statement upon these three sheets correctly reflects and represents the statements and data from which they were prepared."

197 MR. MATTHEWS: The same objections that were made previously will apply to all this line of testimony.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

198 "Those books and records from which I prepared this statement are in my custody. This statement refers to certain returns of certain income items that were not included in the return of annual net income, as well as certain credits and debits to profit and loss which were not included in such return. There has been an examination of the accounts of the Central Pacific Railway Company made by examiners from the office of the Commissioner of Internal Revenue.

"Q. State whether or not the returns referred to in this statement were accepted by the Commissioner of Internal Revenue?"

MR. MATTHEWS: Objected to on the grounds heretofore stated. The fact that the Commissioner of Internal Revenue did or did not acquiesce in the returns made by the Central Pacific Company or by any revenue agent's

Testimony of C. P. Lincoln—Direct.

report upon an examination made of the Central Pacific Company's books, is incompetent, irrelevant and immaterial and has no bearing on this case, and not binding upon the Government. This objection is in addition to the grounds of objection made to this witness's testimony heretofore. 199

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

"A. They were accepted at the time, but later, some time the early part of 1914, it is my recollection, the investigation of the special agents from the Treasury Department resulted in an additional tax being levied against us, claiming that during the years 1910, 1911 and 1912, some items of income had been omitted and that we had deducted excessive interest in each of those years. The letter dated February 11, 1914, from the Commissioner of Internal Revenue, addressed to the Central Pacific Railway Company, indicates what I had in mind when I stated that certain items had been disallowed. In the Commissioner's letter the meaning of the phrase, 'excessive interest' is as follows: In our return of the annual net income based on forms CT-1 and CT-2 appeared an item "Profits from Leasehold Operations'. In arriving at those profits we deducted the full amount of interest on funded debt. In doing that the Revenue Department claimed that we deducted more than the law allowed to the extent of the amount shown in Mr. Osborn's letter. The amount of the funded debt of the Central Pacific Railway Company exceeded the amount of its capital stock, approximately to the extent of the amounts named in Mr. Osborn's letter of Feb- 200 201

Testimony of C. P. Lincoln—Direct.

202 ruary 11, 1914. This relates to interest, but the aggregate amount of the funded debt of the Central Pacific Railway Company exceeded the aggregate amount of its capital stock, as of December 31, 1913, for example, by \$104,769,048.26, the outstanding capital stock being \$84,675,500, and the funded debt being \$189,444,548.26.

"Q. Then as I understand it, the Commissioner of Internal Revenue would only allow you to deduct interest in so far as that interest represented payments upon the funded debt. In excess of that you could not claim any interest payments?"

203 MR. MATTHEW: Objected to on the ground that it is leading.

MR. BUCK: The question is withdrawn.

204 "The item of so-called 'excessive interest', \$1,668,448.23, represents the difference between the interest charged by us in arriving at the profits from leasehold operations and what the Internal Revenue Department claimed that we were entitled to deduct under the law. As to whether or not this item of so-called excessive interest was actually paid by the Central Pacific Railway Company, well, the interest on funded debt was considered as actually paid, because it was taken in the accounts of those years, although it is just possible some of it may not have been paid right at the dates shown. It was considered as paid and in that way this interest was actually paid by the Central Pacific Railway. The Southern Pacific Company pays the interest and charges it to the Central Pacific Railway Company, making the Central Pacific Railway Company actually pay it."

MR. BUCK: The plaintiff now offers in evidence the statement heretofore referred to by

Testimony of C. P. Lincoln—Direct.

witness consisting of three sheets, the first 205
page of which is headed Central Pacific Rail-
way Company Statement of Income for fiscal
year ended June 30, 1910, to June 30, 1914, both
inclusive, as prepared for a return of annual
net income, and asks that it be marked Plain-
tiff's Exhibit N, the offer including all three
sheets.

MR. MATTHEWS: I object to the introduction
in evidence as Exhibit "N" on all the grounds
stated in my objection to the introduction of
Exhibit "G", and on the additional ground
that the statement is in part a self-serving 206
declaration and that any income statement or
figures showing net income that may have been
accepted by the Commissioner of Internal
Revenue, so far as the Central Pacific Railway
Company is concerned would not be binding
on the defendant in this case, wherein only the
Southern Pacific Company's books are in-
volved.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The statement last referred to was received
in evidence and marked Plaintiff's Exhibit N.
This exhibit was read to the jury and a copy 207
is hereto annexed and made a part hereof.

"The letter dated February 11, 1914, to the
Central Pacific Railway Company, from Mr.
Osborn, the Commissioner of Internal Revenue,
was received by me in the ordinary course of busi-
ness. The stamp upon it indicates that we received
it February 16, 1914."

MR. MATTHEWS: Not waiving any objections
to the admissibility of the letter, I concede that

Testimony of C. P. Lincoln—Direct.

208 this is an original letter addressed by Commissioner Osborn to the Central Pacific Railway Company.

“In this letter under each of the years 1909, 1910, 1911 and 1912 are the items of the excessive interest. The explanation that I have already given in reference to the items of excessive interest applies to each of these years.”

MR. BUCK: I offer that letter in evidence and ask that it be marked Plaintiff's Exhibit O.

209 MR. MATTHEWS: Objected to on the ground that it is irrelevant, incompetent and immaterial, and has no bearing whatever upon any of the issues in this case.

MR. BUCK: This is offered for the purpose of showing to what extent the Commissioner of Internal Revenue accepted the return of the company and to what extent such returns were disallowed under the income tax law.

210 MR. MATTHEWS: It is also objected to on the ground that it is not competent, to show to what extent the figures of the Central Pacific Railway Company's return were accepted. It does show to what extent they were disallowed. It is competent at any time for the Federal Government to make a further examination of the Central Pacific Railway Company's books and assess and collect additional taxes if the income of the company was erroneously reported. The Government is not bound by errors or omissions of revenue agents to detect errors in bookkeeping, and is not bound by the books and records of the Central Pacific Railway Company. There is no statute of limita-

Testimony of C. P. Lincoln—Direct.

tions that bars the right of the Government 211
to sue for any additional taxes that may here-
after be found to be due by the Central Pacific
Railway Company for the period covered by
the Commissioner's letter referred to.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The letter last referred to was received in
evidence and marked Plaintiff's Exhibit O.
This Exhibit was read to the jury and a copy is
hereto annexed and made a part hereof.

MR. BUCK: I offer in evidence the return of
annual net income for the Central Pacific Rail- 212
way Company for the calendar year 1913,
filed with the United States Collector of In-
ternal Revenue, First District of California,
March 2, 1914, the return herewith offered
being a copy certified to be correct by the
Assistant Secretary of the Treasury, and ask
that such copy, with such certificate, be
marked Plaintiff's Exhibit P, and I also offer
in evidence the return of net income of the
Central Pacific Railway Company for the six
months ending June 30, 1914, filed with the
Collector of Internal Revenue, First District 213
of California, September 28, 1914, the return
thus offered being a copy certified to be cor-
rect by the Secretary of the Treasury, and I
ask that such copy, together with such cer-
tificate, be also marked Plaintiff's Exhibit P,
the two copies being attached together and
covered by one certificate.

MR. MATTHEWS: Objected to on the same
grounds as stated in objections interposed to
Exhibits O and N.

Testimony of C. P. Lincoln—Cross.

214

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The Income Tax returns of the Central Pacific Railway Company for the calendar year 1913 and the six-month period ending June 30, 1914, were received in evidence and marked Plaintiff's Exhibit P. This Exhibit was read to the jury and a copy of so much as is material is hereto annexed and made a part hereof. It is stipulated between the parties that the said copy of these returns was duly certified.

215

MR. MATTHEWS: I will now read the cross-examination conducted by myself of Mr. Lincoln, and I wish now to reiterate the statement I made at that time concerning cross-examining him, namely, by cross-examining this witness, may it be understood that I do not waive any of the objections heretofore taken to his testimony.

"CROSS-EXAMINATION OF MR. C. P. LINCOLN BY MR. MATTHEWS:

216

"The Central Pacific owns a little stock in other corporations. That is not reflected in any of the statements I have prepared and that have been offered in evidence. By a little, I mean it owns some stock in some small companies, like the Sacramento Transportation Company. For instance, it owns stock in the Ogden Union Railway and Depot Company, Newport News and Mississippi Valley Company and McNally Ditch Company. There may be others but I do not recall them just now. In my statements that have been offered in

Testimony of C. P. Lincoln—Cross.

evidence here, I have included the earnings received 217
in the shape of dividends or otherwise on the stocks
owned in the companies mentioned—have been in-
cluded in the statement, Exhibit G. Those com-
panies are companies owning property and some
of them are operating companies. I have not taken
into consideration the net earnings of those com-
panies, whether they have been distributed or not
in making up that statement. Statement G is
based on our fiscal year. I have not prepared a
similar statement on the calendar year. I stated
that Exhibit G contained the entries that are to
be found in the journal and ledger. By that I 218
mean that statement G is an exact copy of the
debits and credits to income and profit and loss.
But it does not contain any other accounts than
may be found in the journal and ledger.

“Q. What accounts that appear in your journal
and ledger have you omitted from statement G?

“A. Well, to answer that question, Mr. Mat-
thews, I would have to show you the balance sheet
of the Central Pacific Railway Company. The ac-
counts are so many. We handled no cash. We
have a cash book and we have what we term cash
transactions. The Southern Pacific Company as
the agent and lessee of the Central Pacific takes 219
care of most of the cash transactions for us, and
keeps account on its books of such transactions. It
has an open account with the Central Pacific Rail-
way Company on its books. In the open account,
it credits the Central Pacific Railway Company
with certain items, and charges it with other items.
It makes payment on account of the Central
Pacific and charges them to the Central Pacific.

Testimony of C. P. Lincoln—Cross.

220 It receives money for the Central Pacific and credits it to the Central Pacific.

221 "A great many of these items that we have just been talking about are transactions between the Southern Pacific and the Central Pacific. It quite frequently happens that the Southern Pacific will find that it owes the Central Pacific a certain amount of money and will enter a credit to the Central Pacific Company's account to the amount that it owes the Central Pacific. And when that amount is credited on the books of the Southern Pacific, the Central Pacific Company, of course, charges the Southern Pacific Company with that amount and it bears interest at the rate of 4 per cent. per annum, based on monthly balances. There is no actual cash settlement between the two companies. So that these entries are the nearest to cash transactions that we have. That applies to all credits and charges, as the case may be, on the Southern Pacific Company's books, that relate to the Central Pacific. Those credits and charges on the Southern Pacific Company's books are repeated on the Central Pacific Company's books, as charges and credits respectively. The net result is actually the same as though cash had actually passed. Referring to Exhibit 222 G, sheet 1, under Deductions from Gross Income, item 'Land Department Expenses', that item represents the expenses of the land department in charge of Mr. B. A. McAllaster, Land Commissioner, and they are expenses in connection with the granted lands of the Central Pacific Railway Company. I do not know the items going to make up the total figures which I have given here. We have books

Testimony of C. P. Lincoln—Cross.

in the office that would show the detail of those 223
figures. I do not know what those details are
though, there are a great many vouchers. I do not
know anything about the activities of our Com-
missioner of Lands, what his duties are, and what
he does. Referring to the next item on Sheet 1
of Exhibit G, under Deductions, Land Department
taxes, that item represents taxes on the granted
lands that we just referred to. There are State
taxes, and I am pretty sure City and County taxes
of the various counties in the States of California,
Nevada and Utah. That item does not include
taxes levied for betterments or improvements to 224
the County and State property. I know that it
does not, because no taxes on additions and better-
ments on County or State property would be paid
for by the Central Pacific Railway Company. It
would have no right to pay taxes on any such bet-
terments.

"Q. You misunderstood my question. Do you
know whether the item Land Department Taxes in-
cludes assessments for local benefits and improve-
ments made by the Federal, City, County and State,
in the vicinity of the lands taxed?

"A. I do not know positively. I cannot answer 225
yes or no, but I think any such taxes would be
operating taxes, taxes on railway property and be
included in the operating taxes of the Central
Pacific Railway Company. These taxes we are
now talking about are taxes primarily on granted
lands. I cannot say positively whether or not many
acres of the granted lands are within improved
sections of the country. My impression though
is that taxes for local benefits would be included

Testimony of C. P. Lincoln—Cross.

226 in our operating railway taxes. They would appear in Exhibit G, sheet 1, against Taxes. It is my opinion that such taxes would appear, there, under Deductions. So that that item, the 7th item on sheet 1, Exhibit G, would include assessments for local benefits. I cannot answer what else that item 7th includes, because the details of that item are worked up in the Auditor of Disbursements office, the same as are the operating expenses, etc. Turning to sheet 2 of Exhibit G, and referring to the second item, Discount on Preferred Stock, entering that item as a credit is in the nature of a cross-
227 entry, because when that preferred stock was issued to the Southern Pacific Company that discount was charged to the Central Pacific by the Southern Pacific and charged by the Central Pacific to profit and loss. Later, they found out that they should not have charged the Central Pacific with that discount but should have accepted the preferred stock at par. Hence this entry. In making this entry, we debited the open account with the Southern Pacific. In other words, the final effect was the stock was issued without a discount. The Southern Pacific Company credited our account by the same amount at the same time. That is, referring to item
228 2 on sheet 2 of Exhibit G, \$141,000, under year ended June 30, 1910.

"Referring to the third item on sheet 2 of Exhibit G, Restatement of Leasehold Operations, that likewise represents a transaction with the Southern Pacific Company, simply an adjustment. In entering up that credit, the \$99,064.27 during year ended June 30, 1910, we debited the Southern Pacific Company. The Southern Pacific Company likewise made an entry on its books crediting the

Testimony of C. P. Lincoln—Cross.

229

Central Pacific with that item during the year ended June 30, 1910. That adjustment was based on a revised statement of receipts and expenses for the years ending June 30, 1906, 1907 and 1908, on account of expenditures for additions and betterments to the Ogden Lucin cut-off, charged to operating expenses during the fiscal years ending June 30, 1906, 1907, and 1908, which, in March, 1909, were charged to additions and betterments and credited to profit and loss. That item was adjusted during the year ended June 30, 1910. I will add that that is copied from a statement that we received from the New York office of the Southern Pacific Company. In other words, in the leasehold settlements for the fiscal years ending June 30, 1906, 1907 and 1908, they undercredited us \$99,064.27, and authorized a charge to the Southern Pacific Company during the year ended June 30, 1910, of that \$99,064.27 to adjust the under credit. They accepted the charge from the Central Pacific Railway Company. They acknowledged that they undercredited us that amount of money in the adjustment of the leasehold operation for those three years, June 30, 1906 to 1908, inclusive. And the Southern Pacific Company acquiesced in the charge made against it during the fiscal year 1910, covered by item 3 of sheet 2 of Exhibit G. That is in the nature of additional rental. Referring to item 11 on sheet 2 of Exhibit G, Proportion of Amounts charged Central Pacific Railway Company, etc., year ended June 30, 1911, \$701,252.22, that was charged against the Southern Pacific. The Southern Pacific Company entered a corresponding credit on its books. Referring to item 16, sheet 2, Exhibit G, Expenditures

230

231

Testimony of C. P. Lincoln—Cross.

- 233 during fiscal year, etc., that item of \$2,209,898.80 was during the fiscal year ending June 30, 1912, charged on our books to the Southern Pacific Company. The Southern Pacific Company entered a corresponding credit on its books to the Central Pacific Company. Referring to item 18, on sheet 2 of Exhibit G, Adjustment of Leasehold Settlements with Southern Pacific Company, that item of \$954,018.81 was charged on your books during the fiscal year ended June 30, 1913. The Southern Pacific Company entered during the fiscal year ending June 30, 1913, a corresponding credit on
- 233 its books to the Central Pacific Company's account. The explanation of item 18 is this: That in arriving at the excess earnings over six per cent. on the capital stock of the Central Pacific Railway Company, during the period shown, that is from June 30, 1906, to June 30, 1911, the Southern Pacific Company originally deducted four per cent. on the preferred stock and six per cent. on the common stock, while they should have deducted 6 per cent. on the preferred as well as on the common. Hence this adjustment of amount of overcharge to the Central Pacific Railway Company in the original settlement. In other words, that is a further ad-
- 234 justment of rental for lease of road. The one adjustment covered the entire period named. I cannot say positively whether or not we had separate figures for the calendar or fiscal years, but I think the statement which we received from the New York office may have shown what they credited in each of the years shown, and what they should have credited, the balance being this \$954,018.81. I cannot tell you the amount of the readjustment that should have been credited for

Testimony of C. P. Lincoln—Cross.

the period January 1, 1909, to July 1, 1909. Our 935
 records do not show that. Turning now to sheet
 3 of Exhibit G, I call your attention to the second
 item under debit 'Property Abandoned'. I cannot
 say how we arrived at the figures opposite that
 item. That detail is worked up in the office of the
 Auditor of Disbursements. The item 'Property
 Abandoned', means just about what it says, that
 certain property was abandoned and to this extent
 I can answer your other question and say that the
 amounts shown represent the difference between
 the cost of that property abandoned, or the esti-
 mated cost where the exact cost is not known, and 936
 the salvage from the property abandoned. I can-
 not say whether or not it takes into consideration
 depreciation that may have accrued between the
 date of its acquirement and the date of its abandon-
 ment. That detail is worked up in the office of the
 Auditor of Disbursements. I cannot state to what
 extent the cost was correctly ascertained and to
 what extent it was estimated. I cannot separate
 the figures of estimated and of actual cost. That
 detail is worked up in the Auditor of Disburse-
 ments' office.

"Referring now to item 3, sheet 3, Exhibit G,
 that item represents certain amounts deemed uncol- 937
 lectible and charged off to profit and loss. I can-
 not tell on what day those accounts were charged
 off, but they were charged off during the year end-
 ing June 30, 1910—subsequent to July 1, 1909.

"Referring now to item 8, sheet 3, Exhibit G,
 Discount on European Loan of 1911, year ended
 June 30, 1911, \$3,861,003.86; year ended June 30,
 1912, \$963,250.97, that item represents discount on

Testimony of C. P. Lincoln—Cross.

- 238 the Central Pacific Railway Company European Loan of 1911, sold during the year ended June 30, 1911. The loan is a 35-year loan and was for 250 Million French Francs. I do not know whether or not there was a provision in the bonds for the retirement of any of them on interest paying dates. None of them have been retired. The discount then covered by item 8 under the year ended June 30, 1911, applies to a loan covering a period of 35 years. The amount of the loan is carried on the Central Pacific Railway Company's books at 5.18 francs to the American dollar, with the result that it is something over 48 millions of dollars. The
- 239 interest rate is four per cent. There was not a fixed discount from par on that loan. The actual discount is as shown on this Exhibit. The second figure, \$965,250.97, under June 30, 1912, is the discount on the proportion of the French loan sold during the year ended June 30, 1912, and during the two years they sold it all. So that the two figures shown opposite item 8, represent the total discount on that loan. That is the loan to which I referred as running for 35 years—the Central Pacific Railway 35-year European loan of 1911. Referring to item 9, sheet 3, Exhibit G, Commis-
- 240 sions and expenses account European loan of 1911, with the figures under the 1911, 1912 and 1913 columns, that item represents commissions and expenses in connection with the European loan of 1911 previously referred to. We did not set up a reserve of the discount and expenses of floating the loan and charge off a proportionate share during each of the 35 years covered by the loan; because under the classification of the Interstate

Testimony of C. P. Lincoln—Cross.

Commerce Commission, we have that privilege. We 241
could have distributed it over the life of the bonds,
but it has always been our custom to adjust it this
way.

"Q. So it has always been your policy to charge
off the discount and floating expenses before you
really suffered the loss?"

MR. BUCK: That is objected to on the ground
that it is not proper cross-examination, and as
irrelevant, immaterial and argumentative.

THE COURT: Objection overruled.

MR. BUCK: Exception.

"A. No, it seems to me that we suffered it as 242
soon as we sold the bonds at that discount. We
took up a liability for the full amount of the par
value of the bonds and we actually received that
much less than our liability; so we suffered the
loss just there and then. That is my theory—I
won't say as an expert accountant. I do not claim
to be an expert accountant. I am an accountant.

"Referring now to item 17, sheet 3, Exhibit G,
interest charged by Ogden Union Railway & D. Co.,
to interest account adjustment, under year ended
June 30, 1913, \$23,778.16, some of this interest
accrued prior to the year 1913. None of it accrued 243
during the year ending June 30, 1913, because of
the fact that it is debited to profit and loss. Some
of it accrued subsequent to January 1, 1909. I
cannot now say how much. My testimony with
respect to item 18, interest on advances to Ogden
Union Railway Company under Union Pacific Rail-
way Company under column year ended June 30,
1913, \$26,281.73, would be the same as that con-
cerning item 17. Referring now to item 22, sheet

Testimony of C. P. Lincoln—Cross.

214 3, Exhibit G, Rental Depot Facilities at Ogden, July 1, 1912, to June 30, 1913, under the column year ending June 30, 1914, \$19,353.09; none of that item is applicable to rental accruing during the year ended June 30, 1914. My testimony would be the same with respect to item 23. Getting back to item 14, on sheet 3 of Exhibit G, rental of certain lands lying between Oakland Pier and Estuary, 1906 to 1912, under year ending June 30, 1913, \$76,693.21, none of that amount accrued during the year ending June 30, 1913. I do not know what the annual rental was of those lands; because that
245 is worked up in either the office of the Auditor of Disbursements or in the Miscellaneous Accounts Bureau of the Auditor's office. I do not know whether the rental was uniform during the years mentioned. I do not now know how much of it accrued prior to January 1, 1909. I might be able to ascertain it.

"Q. Do the books on which statement G is based show it?

"A. From the statement on which the entry was based, that might show by years, you know. The journal may show it by years. Referring now to
246 Item 26, Equipment vacated, sheet 3, Exhibit G, under the column year ending June 30, 1914, that item represents the difference between the cost, or estimated cost where the value is not known, less the salvage on equipment vacated. That item is similar to item 2, Property Abandoned. I do not know the details going to make up that item; the detail is worked up in the office of the Auditor of Disbursements. I cannot state how much of the item \$186,281.33 represents the actual cost of the

Testimony of C. P. Lincoln—Cross.

equipment abandoned and how much of it represents the estimated cost of equipment; that would have to be ascertained from the Auditor of Disbursement's office, as they work up the detail. I do not know how the estimates of value or cost covering the items included in Property Abandoned and Equipment Vacated were made up; nor when the property covered under those two items, 26 and 2, Property Abandoned and Equipment Vacated was originally acquired. That would have to be ascertained in the office of the Auditor of Disbursements. I do not know whether in arriving at the figure under item 26, a deduction was made for depreciation; that would have to be ascertained from the office of the Auditor of Disbursements. The equipment referred to in item 26 was actually vacated during the year ending June 30, 1914. I believe the Southern Pacific Company included that item in its annual report for the year ended June 30, 1914, under the heading 'Depreciation of Equipment' from date of acquirement to June 30, 1913. Item 27, sheet 3, Exhibit G, does not represent depreciation all of which accrued prior to June 30, 1913; it includes depreciation to June 30, 1913, inclusive. None of that depreciation accrued subsequent to June 30, 1913. None of that depreciation accrued during the first six months of 1914. I do not know how the figures opposite item 27, \$4,926,213.06 were arrived at, because they were worked up, I think, by the New York office. It is possible they may be able to tell in the Auditor of Disbursement's office. I do not know the details going to make up that figure. I do not know the date of the acquirement of the equipment on which

Testimony of Mr. Holbrook—Direct.

250 that depreciation is figured. My testimony, with respect to item 28, would be the same as with respect to item 27. Referring now to items 29 and 30, Preliminary Surveys Abandoned, I do not know when they were made. They probably can tell in the Auditor of Disbursement's office. They were abandoned during the year ending June 30, 1914. I make that statement because the expenses were charged off during that year. I know nothing of the details going to make up the figures there, though. As to whether or not the Central Pacific Company derived such benefit from those surveys as
251 to make them a proper charge against the capital account, the Southern Pacific Company carried those surveys on their books, I might say, in suspense, and finally charged them off to the Central Pacific Railway Company during the year ending June 30, 1914, having decided to abandon the project, whatever it was. I cannot say whether or not the surveys were made during the year ending June 30, 1914. They were carried in suspense from the beginning of the expenditures."

Mr. BUCK: I will now read the deposition of Mr. Holbrook as follows:

252

"TESTIMONY OF MR. HOLBROOK:

"DIRECT-EXAMINATION BY G. V. SHOUP:

"My full name is George T. Holbrook. I reside in Berkeley, California. My place of business is Flood Building, San Francisco. I am employed in the Auditor's office of the Southern Pacific. I am not an employee of the Central Pacific. I do not have the handling of any of the books of the Central

Testimony of Mr. Holbrook—Direct.

Pacific Railway Company. Indirectly I review the 253
accounts in connection with the income tax return."

MR. MATTHEWS: I object to all of the questions in this testimony on the ground that he is not competent to testify to the facts in reference to this case, and that the questions and answers are irrelevant, incompetent and immaterial and nothing whatever to do with the issues in this case. This objection may be deemed to be interposed to each and every answer and question without being repeated.

"My chief duties are to review income tax for all companies; also help look after the outside interests in which the Southern Pacific is interested, such as the electric lines in Southern California. I review the returns of the Central Pacific Railway Company. I have been employed by the Southern Pacific since January 1, 1913. I prepared the statement, Exhibit Q, consisting of two sheets, the first sheet of which is headed Central Pacific Railway Company Statement of Income for fiscal year ending June 30, 1910, to June 30, 1913, both inclusive, as prepared for the return of annual net income, showing changes made by Internal Revenue Department. Exhibit Q was prepared 254
from the statement which Mr. Lincoln made up covering income report shown on the CT forms, and report of the Internal Revenue Department. Plaintiff's Exhibit N is the statement to which I referred as having been prepared by Mr. Lincoln and used by me, together with the Commissioner's letter covering additional assessments in preparing this statement. This statement which I prepared follows the statement prepared by Mr. Lincoln, 255

Testimony of Mr. Holbrook—Direct.

- 256 Exhibit N, except that it includes the changes suggested in the amendments referred to in Commissioner Osborn's letter of February 11, 1914. This is shown in Exhibit Q. Likewise in making assessment based upon the 1913 return, a certain item representing bond discount, suffered prior to 1909, was disallowed. Sinking fund appropriation deducted in the 1910 return was also disallowed by the Government in making the assessment, and is so shown on the statement. This statement which I prepared shows all the changes and amendments to the returns made to the Commissioner for the
- 257 period in which it is marked. It covers all."

MR. BUCK: I ask that the statement to which the witness refers, consisting of two sheets, the first sheet of which is endorsed as hereinabove stated, and the second of which is endorsed Central Pacific Railway Company statement of profit and loss for fiscal year ended June 30, 1910, to June 30, 1914, both inclusive, as prepared for the return of annual net income, showing changes made by Internal Revenue Department, be admitted in evidence and marked Plaintiff's Exhibit Q.

258

MR. MATTHEWS: Objected to on the grounds, first, that the exhibit offered is not the best evidence of the facts therein purported to be set forth, subject to Exhibit 2-I. Second, on the ground that the exhibit consists practically of conclusions. Third, that the contents of the exhibit are irrelevant to the issues in this case. Fourth, that it is immaterial. Fifth, that the exhibit is incompetent to prove the facts therein purported to be set forth and is not

Testimony of Mr. Holbrook—Direct.

the proper way to prove such facts. Sixth, 259
 that the exhibit assumes the correctness of the
 entries and figures, and there has been no
 proof of the correctness of such figures and
 entries. Seventh, there has been no evidence
 showing the exact method of accounting and
 bookkeeping used in compiling the books on
 which the Exhibit is based, and the exhibit
 for that reason is ambiguous and misleading
 and has not been sufficiently explained and
 interpreted. Eighth, it is competent at any
 time for the Federal Government to make a
 further examination of the Central Pacific 260
 Company's books and direct and collect addi-
 tional taxes if the income of the company was
 erroneously reported. The government is not
 bound by errors or omissions of revenue agents
 to detect error in bookkeeping, and is not
 bound by the books and records of the Central
 Pacific Railway Company. There is no statute
 of limitations that bars the right of the Gov-
 ernment to sue for any additional taxes that
 may hereafter be found to be due by the Central
 Pacific Company for the period covered by the
 Commissioner's letter referred to. 261

THE COURT: Objection overruled.

MR. MATTHEW: Exception.

The statement last referred to was received
 in evidence and marked Plaintiff's Exhibit Q.
 This exhibit was read to the jury and a copy
 is hereto annexed and made a part hereof.

"I prepared the statement headed Central Pacific
 Railway Company, Statement, showing income and

Testimony of Mr. Holbrook—Direct.

963 profit and loss upon which Income Tax was paid for fiscal years June 30, 1910 to June 30, 1914, inclusive (payments made on basis of calendar year). It is really a summary of Exhibit Q."

MR. BUCK: I offer that in evidence and ask that it be marked Plaintiff's Exhibit R.

MR. MATTHEWS: Objected to on all the grounds of objection interposed to Exhibit Q.

THE COURT: Objection overruled.

MR. MATTHEW: Exception.

964 The statement referred to by the witness as a summary of Exhibit Q was received in evidence and marked Plaintiff's Exhibit R. Exhibit R was read to the jury and a copy is hereto annexed and made a part herof.

"I prepared the statement 'Central Pacific Railway Company—statement showing excess of dividends paid over taxable net income, including profit and loss transactions, for fiscal year ending June 30, 1910, to June 30, 1914, inclusive'. That statement shows how the dividends compare with the amount of taxable net income and taxable profit items on which the income tax would be paid
964 for the fiscal years ended June 30, 1910, to June 30, 1914, inclusive. That is, upon the basis of the return of income as amended by the Government—as finally amended."

MR. MATTHEWS: I move to strike out the answer on the ground that the word "finally" is a conclusion of the witness.

Testimony of Mr. Holbrook—Direct.

THE COURT: Motion denied.

265

MR. MATTHEWS: Exception.

"My answer is then, 'as amended by the Government'. This statement shows the surplus for each year during this period upon this basis. For the year ending June 30, 1914, this statement shows the surplus of that year before payment of dividends and surplus after dividends are paid. The figures under net profit and loss show that the net result of the profit and loss item is a loss. The red items on sheet opposite dividends paid in excess of surplus indicate that the dividends exceeded the surplus for the year."

266

MR. BUCK: This statement, consisting of three pages, is offered in evidence and I ask that it be marked Plaintiff's Exhibit S.

MR. MATTHEWS: I offer the same objections as interposed to Exhibit R.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

The statement last referred to by the witness was received in evidence and marked Plaintiff's Exhibit S. This exhibit was read to the jury and a copy is hereto annexed and made a part hereof.

267

"I prepared the statement headed Central Pacific Railway Company, Summary showing excess of dividends over taxable income and profits reported on returns of annual net income, period covering fiscal years ended June 30, 1910, to June 30, 1914. That statement is a summary of Exhibit S. It shows that the dividends of the same period have

Testimony of Mr. Holbrook—Direct.

268 exceeded the income and profits upon which tax has been paid to the Internal Revenue Department, for the period representing the fiscal years ending June 30, 1910, to June 30, 1914, inclusive."

MR. BUCK: This paper is offered in evidence and I ask that it be marked Plaintiff's Exhibit T.

MR. MATTHEWS: Objected to on the ground interposed to Exhibits R and S.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

269 The statement last referred to by the witness as a summary of Exhibit S was received in evidence and marked Plaintiff's Exhibit T. Exhibit T was read to the jury and a copy is hereto annexed and made a part hereof.

"Q. I call your attention to a certified copy of the return of annual net income, filed by the Central Pacific Railway Company, for the year ending December 31, 1913, and would ask you to state, if you know, what action, if any, was taken by the Government officials relative to the amendments or changes in that statement?"

270

MR. MATTHEWS: Objected to on the same grounds as interposed to the Exhibits themselves.

MR. BUCK: This company was leased to the Southern Pacific and in January and February the tax was an excise tax and we deducted the income for those two months on the ground that being leased, the Central Pacific Railway

Testimony of Mr. Holbrook—Direct.

Company was not subject to an excise tax, and 271
the Government disallowed that and—finally
the amended return showed the full income for
the year and not for the ten months.

THE COURT: The objection is overruled.

MR. MATTHEWS: Exception.

“A. With regard to the action taken as to the re-
turn of annual net income for the calendar year end-
ing December 31, 1913, the assessment did not agree
as to amount with the taxable liability shown op-
posite ‘annual net income upon which one percent
is calculated.’ A deduction representing 1/6th of 279
the income is claimed by the company, but this was
evidently disallowed by the Government as the tax
was paid upon the full amount. At the bottom of
the return it was inserted that certain bond dis-
counts had been claimed as a loss against item 5A.
This deduction was also evidently disallowed by the
Government in making the assessment. With these
changes made the tax was levied as based upon
the return. With reference to the return for the
six months ending June 30, 1914, there was a defi-
cit reported. To my knowledge no assessment no-
tice was issued and none received—as far as I
know. The returns of the annual net income filed 273
by the Central Pacific Railway Company for
the calendar years 1910-1912 have been checked
by the Internal Revenue Department. As to check-
ing of the returns subsequent to calendar year 1913,
no action has been taken as far as I know.”

MR. MATTHEWS: If your Honor please, I will
now read the cross-examination of Mr. Hol-

Testimony of Mr. Holbrook—Cross.

274

brook, and I desire to make the statement now that I made then with reference to the waiving of any objections, namely, by cross-examining this witness, may it be understood that I do not waive any of the objections heretofore taken to his testimony.

"CROSS-EXAMINATION OF MR. HOLBROOK BY MR. MATTHEWS:

275

"I prepared Exhibits Q, R, S and T. I did not prepare these from the books of the Central Pacific. They are based entirely on statements prepared by Mr. Lincoln, and also from various memoranda, C. T. forms, of which we had copies. These C. T. forms are used in preparing Returns of Annual Net Income. These C. T. forms covered the calendar years 1909, 1910, 1911, 1912 and 1913, and the six months ending June 30, 1914. Exhibit N is in part the basis for exhibits Q, R, S, and T, as prepared by me. The C. T. forms which I refer to, are forms similar to those on which K and L are written. K and L cover only the year 1913, and the six months ending June 30, 1914, respectively. I used the C. T. forms commencing with the calendar year 1909 and up to and including the six months ending June 30, 1914. The C. T. forms which I refer to, are similar to K and L. I used the C. T. forms and Exhibit N as the basis for Exhibits Q, R, S and T. I also took into consideration various deductions disallowed by the Internal Revenue Department, based either upon assessment notices or upon letter written to the Central Pacific Railway Company, covering and explaining addi-

276

Testimony of Mr. Holbrook—Redirect.

tional assessments. Exhibit O, the letter of the Commissioner of Internal Revenue, is the only letter to which I refer. That is the only letter which we received covering the additional assessment. The other deductions disallowed being not explained by any letter. 277

"MR. MATTHEWS: I think that is all."

MR. BUCK: I will now read the remainder of his deposition:

"The exhibit to which I refer as having been based upon a summary prepared by Mr. Lincoln and the C. T. forms of Exhibit Q, in making and preparing this statement, Exhibit Q, I assumed that the statements of account as prepared in Exhibit N was correct. Now, in addition to using that statement I also used forms C. T. No. 1 and C. T. No. 2. We have in our office records copies of the returns made to the Government upon these forms of the years embraced in the Exhibit Q. We have copies or files of the forms 1 and 2 and also copies of the report made to the Government for the Return of the Annual Net Income. So in preparing Exhibit Q and in showing the items that were included in that return, as well as the items that were included in such return, I relied first upon miscellaneous statements marked Exhibit N and next I checked Exhibit N against the copies of the C. T. forms, which I had on file in the office. Incidentally, I might say that previously I had checked the C. T. forms for the calendar years 1913 and the six months ending June 30, 1914, against the final balance sheet issued by the Central Pacific 278 279

Testimony of Mr. Holbrook—Redirect

280 Railway Company for those particular periods. They checked; they correspond with the balance sheet. The C. T. forms are merely used by the company for guidance in making up the income tax return. Copies of the C. T. forms are kept. I referred to those copies in making up the statement. I looked over those forms.

281 "In order to ascertain the items that were added or deducted by the Internal Revenue Department, I had to guide me various data: first, Exhibit O, consisting of a letter addressed to the Central Pacific Railway Company by the Commissioner of Internal Revenue, W. H. Osborn, the letter being dated February 11, 1914; second, various memoranda as to the 1910 assessment, which we had on our files, indicating that certain items representing Sinking Fund Appropriation had been disallowed by the Internal Revenue Department in making assessment for that particular year. The memorandum referred to is in shape of a protest, in which we claim the item should be allowed; and third, as to the year, 1913, I checked up a copy of the voucher which we had issued in payment of the tax for that year, as to the amount of payment. Also reviewed copy of protest which we had on our files covering
282 such payment. The amount of the voucher showing that assessment notice did not correspond in amount with the liability conceded by the company. This is furthermore brought out by the protest which stated that the company should be allowed a one-sixth deduction of the net income reported for the year. It is also claimed in the return that certain allowances should be made for bond dis-

Testimony of Mr. Holbrook—Redirect.

count for bonds sold prior to January 1, 1909. This 283
 item was disallowed by the Government in making
 its assessment. Exhibit Q correctly represents the
 income of the company, including profit and loss,
 for the period mentioned in such statement as pre-
 pared for the Return of the Annual Net Income as
 amended by the Commissioner of Internal Revenue.
 All disallowances or additional assessments for the
 years 1910 to 1912 as recommended by the Com-
 missioner of Internal Revenue, were based upon
 the calendar year; whereas, for the purpose of state-
 ment, that is Exhibit Q, additional assessments were
 modified on the basis of fiscal year records. That 284
 is, they were apportioned on fiscal year basis instead
 of calendar year in the preparation of the state-
 ment."

MR. MATTHEWS: I object further to all of the
 exhibits that have been introduced from Ex-
 hibit G to Exhibit T inclusive, on the ground
 that these exhibits show figures on basis of
 fiscal years, whereas the figures, if competent
 or material at all, should be on the basis of
 calendar year.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

THE COURT: Do you object to the method of 285
 bookkeeping?

MR. MATTHEWS: I do not object to their
 method of bookkeeping. They can by working
 up these balance sheets get the figures out on
 the basis of the calendar year just as easily as
 they can on the fiscal year.

MR. BUCK: And I call attention to the fact
 that Mr. Matthews, if we had undertaken to

Testimony of Mr. Adams—Direct.

286

make up the statement that way, would have attacked them more vigorously, as not being exact copies of entries in the corporate books. The Central Pacific's property is leased to the Southern Pacific and the rent is payable annually, so that we have to make up statements for the whole year and that year by statute is the fiscal year ending June 30.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

287 "I based Exhibit Q on fiscal year basis primarily instead of calendar year because Exhibit N is drawn up on the same basis; that is on the fiscal year basis. The corporate books of the Southern Pacific were kept on fiscal year basis. Such fiscal year ends June 30th and corresponds with the time upon which the annual reports and various statements to the Interstate Commerce Commission are made. The Central Pacific Company takes out monthly balance sheets."

MR. BUCK: I will now read the deposition of Mr. Robert Adams:

"TESTIMONY OF MR. ADAMS:

288

"DIRECT-EXAMINATION BY MR. SHOUP:

"My name is Robert Adams. I reside in Oakland, California. I am an assistant auditor of the Southern Pacific Company. I am not an officer of the Central Pacific Railway Company. As Assistant Auditor of the Southern Pacific Company, I assist in the direction and supervision of the work of the accounting department of the Southern

Testimony of Mr. Adams—Direct.

Pacific Company's Pacific System and its proprietary and affiliated companies. The Auditor of the Southern Pacific is Mr. T. O. Edwards. I have supervision of the accounts of the company and as assistant to the auditor, Mr. Edwards, direct and supervise the work of the corporate accounting of the lessor companies. When I speak of the corporate accounts of the lessor companies, I include in that particularly the companies that comprise the Pacific system, i. e., Central Pacific Railway Company, Southern Pacific Railroad Company, South Pacific Coast Railway, and the Oregon and California Railroad. The Southern Pacific Company keeps the earnings of these various lessor companies. All earnings and receipts are in the custody of the Southern Pacific Company.

"Q. If the lessor or subsidiary companies need moneys for additions and betterments, or to make up a deficit, what company advances such money?"

MR. MATTHEWS: I object on the grounds that it is incompetent, irrelevant and immaterial and has nothing whatever to do with the issues in this case; also move to strike out the answer to the question heretofore asked this witness on the same grounds, and ask that this objection be taken to apply to all subsequent questions and answers.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

"A. The Southern Pacific Company. All such transactions are correctly stated in the accounts of Southern Pacific Company and lessor company. No distinction is made as to the ownership of such

Testimony of Mr. Adams—Direct.

292 funds from these various transactions, except as the book accounts show the balances as they stand between the lessor company and the Southern Pacific Company. In round numbers, a hundred employees are employed in the office of the auditor of disbursements in the San Francisco office. There may be a few, more or less, of that number. There are about ninety in the Miscellaneous Accounts Bureau, San Francisco."

293 **MR. MATTHEWS:** Of course, I do not know the purpose of these questions and it may be that my general objections will not cover specific objections I may want to make later, when such purpose is learned.

MR. BUCK: The purpose in asking these questions is to show the impracticability of going back of the reports that are furnished to Mr. Lincoln and upon which the journal and ledger entries are made, in order to verify the correctness of such reports. In other words, if you should attempt to call all the different persons concerned in the making of these reports, it would necessitate taking endless testimony.

294 **MR. MATTHEWS:** I merely made the statement in order that my objections, without question, be held to apply to all of the questions and answers, and when the questions and answers are offered in evidence in Court, I will not be held as having waived my objections to any exhibit or evidence.

"In the Assistant Treasurer's office, San Francisco, there are less than twenty employees, fifteen

Testimony of Mr. Adams—Cross.

about. The Auditor of Disbursements gets his 293
figures from labor and material distribution, which
he receives from various sources, and particularly
from the Division Superintendent's Office, of which
there are ten in the Pacific System. The Miscel-
laneous Accounts Bureau receives its data from
other accounting offices: the auditor of freight
accounts, auditor of passenger account and auditor
of disbursements; also from the treasury office
and from station agents, conductors, etc. The re-
ports of the Assistant Treasurer's office are based
upon the receipts and disbursements of the Com-
pany, the receipts coming very largely from the 296
station agents and conductors from other railroad
companies and from the public for bills rendered.
The disbursements are of the company's pay roll,
vouchers and drafts drawn in settlement of traffic
balances. These receipts and disbursements are
entered on abstracts and reported to the Miscel-
laneous Accounts Bureau daily."

MR. MATTHEWS: I will now read the cross-
examination of this witness, and in doing so
I wish to make the statement that I made all
through, about the waiving of any objections,
namely, by cross-examining this witness may 297
it be understood that I do not waive any of
the objections heretofore taken to his testi-
mony.

"CROSS-EXAMINATION BY MR. MATTHEWS:

"Those reports are the reports of the opera-
tions of the Central Pacific by the Southern Pacific
Company, as well as of the operations of the other
companies, namely, the Southern Pacific Railroad

Testimony of Mr. Adams—Cross.

298 Company, South Pacific Coast, Oregon and California, all of which are known as the Pacific System. What I have said applies to the Central Pacific and to each one of the companies named as well. The receipts and disbursements (i. e., income and expenses) of the Southern Pacific Company are all booked, showing what is account of operation of Central Pacific, what is S. P. R. R., S. P. Coast and what is O. & C. I can tell from those reports the proportionate part of the Central Pacific Railway Company's business. Those reports finally show the total results of the operations of each one of those companies. I mean that

299 the Central Pacific is kept separate and independent of each of the other lines, with the figures that relate to it. That is true of each of the other roads that I mentioned—of the earnings and expenses of those companies. These operations so far as they relate to the Central Pacific Railway Company are in accordance with agreements that heretofore have been made between the Southern Pacific Company and the Central Pacific Railway Company, in accordance with the lease between the two companies. That lease was offered in evidence and marked Exhibit E. The provisions of that lease

300 as amended are observed by both corporations very strictly. The earnings of the Southern Pacific Lines are accounted for with great care. Great care is used in the apportionment of expenses and revenue between our companies. Business local to the Central Pacific Railway Company, is credited to its earnings. To illustrate, freight moving between two points on the Central Pacific Railway Company would be credited wholly to that com-

Testimony of Mr. Adams—Cross.

pany; likewise a passenger movement or any other 301
item that can be located. Traffic handled on two
or more lessor companies is apportioned on the basis
of the relative mileage traveled over each. Not
just exactly the same as you would apportion the
share of the earnings between the Southern Pacific
Line and of an entirely independent line; because
the settlements between two foreign companies are
not always on the exact mileage basis. There
would be a slight difference in the division per-
haps. It would be the same in general, subject only
to such changes as might be effected by agreements
between the different lines. The method of appor- 302
tionment is practically the same. In accounting
for the earnings of the separate roads, we carry
that down all the way through the books. In our
work we are guided by the principles and rules laid
down by the Interstate Commerce Commission. I
would not say that we treat the Central Pacific
as an independent corporation and the Southern
Pacific as an independent corporation and that the
relations between them are as between two corpo-
rations, separate and distinct from each other, for
the purpose of accounting. What accounting we
do is done for the purpose of arriving at proper
settlement in accordance with the terms of the 303
lease referred to. For the purpose of account-
ing and complying with the terms of the lease,
I would say that we treated the two com-
panies as independent corporations. I am not an
employee of the Central Pacific Railway Company.
I am not paid by the Central Pacific Railway Com-
pany, but a portion of my salary, as is the salary
of all employees of the accounting department and

Testimony of Mr. Adams—Cross.

304 general office employees, is paid by the Central Pacific Railway Company in that it is charged against the operation of the Central Pacific Railway Company, though it is paid by one check from the Southern Pacific Company. That charge against the Central Pacific is to take care of the expenses incurred by the Southern Pacific in its operations under the lease, and which under the lease are chargeable to the Central Pacific. But my employment is solely by the Southern Pacific Company. That company charges a portion of my salary against the Central Pacific only as it
305 charges other expenses against the Central Pacific, that are likewise proper charges under the terms of the lease. The employees of the two companies, the Southern Pacific and the Central Pacific Railway Company, are not in all cases the same men. There are certain employees who devote their entire time to the work of the lessor companies, such as Mr. C. P. Lincoln, Mr. Johnson, Mr. Ellis, who are employed in the corporate accounts Bureau of the lessor companies. They handle the accounts not only of the Central Pacific Railway Company, but for the other companies of the Pacific System. They are not connected in any way with the Southern Pacific Company. Their work has entirely to
306 do with those companies. They are independent entirely of the Southern Pacific Company. They are outside of the Southern Pacific Company's accounts, being the accounts of those lessor corporations. When the Southern Pacific Company makes additions, improvements or betterments to the Central Pacific Lines, it charges up the cost of such improvements to the Central Pacific Company. It keeps strict account of all such charges. The

Testimony of Mr. Adams—Cross.

books show every transaction, whether it is a new bridge, new building, new equipment or what not. 307

"Q. Then you would say that a distinction is made between the funds of the Southern Pacific Company and the funds of the Central Pacific Company?"

"A. The Central Pacific Railway Company has funds as it receives them in leasehold settlements with the Southern Pacific Company, which are credited to its account and continued in use in the business of the Southern Pacific Company. While no separate cash drawer is kept, a distinction is made between the charges applicable to the Central Pacific and all these other companies. A practical distinction is made as to the debits, credits, expenses and operations of all kinds between the Central Pacific and the Southern Pacific, and of the other subsidiary companies going to make up the system. Each corporation stands on its own bottom, and the settlement made between each one of the companies and the Southern Pacific Company is of course in accordance with the terms of the lease. The Southern Pacific Company, being the lessee, operates the line and collects the money. I have seen the names often of the directors of the two companies, the Southern Pacific Company and the Central Pacific Railway Company, but I could not name them at the present. The Board of Directors are not identical between the two companies. They have separate boards of directors. The directors of the Southern Pacific Company are not the same as the directors of the Central Pacific Railway Company." 308 309

MR. BUCK: I will now read the redirect-examination.

Testimony of Mr. Adams—Redirect—Recross.

310 "REDIRECT-EXAMINATION BY MR. SHOUP:

"The employees under these officers that you have mentioned, namely, the auditor of disbursements, miscellaneous accounts bureau, and assistant treasurer's office, all handle the various accounts of these various companies. There is no one separate employee in any of these offices who handles the Southern Pacific accounts."

311 "MR. SHOUP: When I say that they handle all the accounts of those companies, I mean that they handle the accounts that pertain to the operations of those lessor companies, but they are Southern Pacific accounts, and they perform the necessary work of segregating and distributing the revenue and expenses between the lessor companies.

312 "Mr. Edwards' salary is apportioned as an expense to each of these various accounts as my salary is. The Pacific System of the Company embraces the line from Portland, Oregon, on the North, to the Rio Grande at El Paso, and from Ogden, Utah, on the east to San Francisco, including main and branch lines of 7000 miles, operating in the States of Utah, Nevada, Oregon, California, Arizona and New Mexico. The Central Pacific Railway Company extends through Utah, Nevada and California; I believe it also extends into Oregon. The approximate mileage of its railway lines is about 2300 miles."

MR. MATTHEWS: I will now read the recross-examination:

"RECROSS-EXAMINATION BY MR. MATTHEWS:

"The directors of the Central Pacific Railway Company hold regular meetings. Those meetings

Testimony of Mr. King—Direct.

are not in connection with the directors' meetings 313
of the Southern Pacific. The corporate organiza-
tion of the Central Pacific has been kept up and
it is still a corporation in all respects. It is
separate and distinct from the Southern Pacific."

MR. BUCK: I will now read the deposition
of Mr. King:

"TESTIMONY OF MR. KING:

"DIRECT-EXAMINATION BY G. V. SHOUP:

"The printed copy handed me of the Articles of
Association and Amendments of the Central Pacific 314
Railway Company is a copy of the original Articles
of Association and Amendments of the Central Pa-
cific Railway Company, of which I am Secretary."

MR. BUCK: I offer this in evidence and ask
that it be marked Plaintiff's Exhibit U.

MR. MATTHEWS: This is objected to not on
the ground that it is not a true copy of the
certificate of incorporation, but I reserve all
other grounds of objection, and object now gen-
erally on the ground that it is irrelevant, im-
material and incompetent and has no bearing
upon the issues in this case.

MR. BUCK: This shows also, your Honor, 315
that it is a foreign corporation, and I want
to show that fact in connection with the pro-
vision of the N. Y. Code of Civil Procedure as
to proving transactions of foreign corpora-
tions.

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

Testimony of Mr. Lincoln—Redirect.

316

The said copy of Articles of Association (and of amendments thereto) of the Central Pacific Railway Company was received in evidence and marked Plaintiff's Exhibit U. This exhibit was read to the jury, and so far as material shows that the said Company is a Railroad Corporation organized and existing under the laws of the State of Utah, and that the said Company was incorporated in the year 1899.

MR. BUCK: I will finish the deposition of Mr. Lincoln:

317

"TESTIMONY OF MR. LINCOLN:**"REDIRECT-EXAMINATION BY MR. H. W. HOBBS:**

"I have testified that Exhibit G is a copy of the entries in the books of the Central Pacific Railway Company. It is made by fiscal years. It has been testified that the Central Pacific also makes out monthly balance sheets. These monthly balance sheets do not show the total operating revenue. The operating revenue is taken up on the books of the Central Pacific Railway Company in June of each year. It would not be possible to make from
318 the balance sheets of the company a statement corresponding to Exhibit G on calendar years."

MR. MATTHEWS: If your Honor please, at the beginning of the testimony, after Mr. Lincoln was recalled, Mr. Hobbs began the examination, but Mr. Shoup previous to that time had been examining the witness and all the other witnesses; and I object to the cross-examination of witnesses by counsel other than

Testimony of Mr. Lincoln—Redirect.

the one who examined him in-chief. Also, I 319
think that should be "Examination" and not
"Cross Examination".

THE COURT: Objection overruled.

MR. MATTHEWS: Exception.

"It would not be possible to make from the balance sheets of the company a statement corresponding to Exhibit G on calendar years. I stated yesterday that in preparing Exhibit G I took into consideration all earnings of Central Pacific Railway Company received from other corporations in which it owned stock.

"Q. In the preparation of your first income returns to the Government did the Central Pacific Railway Company take the position that the profits of leasehold operations were in the nature of a rental?" 320

MR. MATTHEWS: Objected to on the ground that it is absolutely immaterial what position the Central Pacific Railway Company may have taken in its returns, and on all the grounds heretofore stated at length. The question is as to the fact.

MR. BUCK: It shows the basis on which these returns were made up. 321

THE COURT: I will take it.

MR. MATTHEWS: Exception.

"A. It took the position that the operations, the leasehold operations during the fiscal year which ended June 30, 1909, were earned during the calendar year of 1909 for the purpose of preparing the returns of annual net income for the calendar year ending December 31, 1909.

Testimony of Mr. Lincoln—Redirect.

- 322 **"Q.** In the re-examination of the books of the Central Pacific Railway Company was that attitude allowed by the Government?"

MR. MATTHEWS: Objected to on the same ground and to save encumbering the record by objections to each question and answer, may it be understood that an objection on the grounds stated in my several objections to this witness's testimony may be considered as having been made to all following questions and answers without further stating.

THE COURT: Objection overruled.

- 323 **MR. MATTHEWS:** Exception.

"A. There was no objection to that on the part of the Government because, of course, it was greatly favorable to the Government. That statement included actual earnings for the six months ending December 31, 1908.

"The Government did not accept this net amount as the total income of Central Pacific Railway Company. They claimed that in arriving at that amount that we deducted too much interest as we had deducted the full amount of the interest on the outstanding funded debt.

- 324 **"Q.** Did the Government assume that Central Pacific Railway Company had a gross income, a gross operating revenue and net operating revenue on the re-examination of those books?

"A. Well, they analyzed that profit from leasehold operations and in that way ascertained just how we arrived at the amount. In other words, this profit from leasehold operations which is in the nature of a rental, they did not accept as a rental payment, but they went beyond that figure

Testimony of Mr. Lincoln—Redirect.

to ascertain what it did represent. All returns since 325
the re-examination, have simply returned the net
amount received from leasehold operations—just
the net amount of leasehold operations, as we did in
the original returns. We follow that same operation
today. I think in the preparation of the 1914 and
1915 returns that we made a separate showing of the
interest on the outstanding funded debt. The item
of bond discount also figured in this re-examina-
tion as too great a deduction. It has always been
the practice of the Company to deduct or charge
the total amount of bond discount and flotation ex-
pense to profit and loss of the year of the sale of 326
the bonds. In our returns of annual net income
we attempted to include the entire amount; but the
Government objected to that, claiming that it
should be pro rated over the life of the bonds; and
we are now deducting a *pro rata* of that discount.
So far as our books are concerned the whole of
that amount has already been deducted or has been
charged. The deductions of bond discount as al-
lowed in the final amended returns are all shown
on this exhibit prepared by me and in evidence as
Plaintiff's Exhibit N. If bonds are retired before
maturity, reacquired at a discount, it is the prac-
tice to credit that discount to profit and loss. 327
If the total loss is not suffered by way of dis-
count that fact is properly reflected on the books
of the company. Under the rules of the Interstate
Commerce Commission we are permitted the op-
tion of charging off the whole of the flotation ex-
pense in the year of the sale of the bonds, the same
as the bond discount. There is no way by which
the company can retrieve any of that flotation ex-

Testimony of Mr. Lincoln—Recross.

398 pense as they could the bond discount. While there is a possibility of retrieving part of the loss suffered by way of bond discount that possibility does not exist as to flotation expense. The Central Pacific Railway Company charges the total of the flotation expense to the income or profit and loss account in the year of the sale of the bonds."

MR. MATTHEWS: I will now read the recross-examination:

"RECROSS-EXAMINATION BY MR. MATTHEWS:

399 "I stated that it was impossible to make out a statement in the form of Exhibit G based on the calendar year instead of the fiscal year. I meant to make such a statement. Because the leasehold operations are not taken up on the books of the Central Pacific Railway Company until June of each year, with the result that if you take any balance sheet other than June of each year it will not show the accrued leasehold operations of that fiscal year.

330 "Forms CT1 and 2, on which Exhibits K and L are written, are not exactly the same forms now known as 'CT-1' and '2'. They have been changed recently because now we make the return on the fiscal year basis and do not require the five columns on those forms that we did when we returned on the calendar year basis. I do not think that there had been changes in these forms between the first forms used in 1909 and the forms now in evidence as Exhibits K and L. I am almost sure there have been no changes. Under the Interstate Commerce Commission's rulings it is optional to either charge off discount on a bond issue, in a

Testimony of Mr. Lincoln—Recross.

lump sum or *pro rate* it over the period of years 331
the bonds are to run. Referring again to Exhibit
G, sheet one, under 'Deductions from Gross In-
come', item 'Operating Expenses', I have not the
details of the items going to make up the total
amounts for the years indicated. I do not know
what items are included in those totals. Our books
do not show what items are included in those to-
tals."

MR. BUCK: Now, Mr. Shoup says this:

"MR. SHOUP: Is it agreeable to you, Mr. 332
Matthews, to have it understood that all ex-
hibits heretofore offered in evidence on behalf
of the plaintiff in taking this deposition may
be considered as having been re-offered? In
view of the fact that the testimony of these
witnesses is now completed I will now make
the offer subject to all the objections made by
you to the offer of these exhibits, which are
of the same force and effect as if these objec-
tions had been repeated."

MR. MATTHEWS: And I said:

"That is agreeable and I include in my ob- 333
jections to the reception in evidence of these
exhibits all the grounds of objection stated in
each and every objection made in the record as
made up before Major Sime, whether stated
to one exhibit or another to be deemed as to
include each and every exhibit as here made in
detail and a motion is made to strike out all
the exhibits on the grounds of objections here
included and also to strike out all testimony

Testimony of Mr. Lincoln—Redirect.

234 of each of the witnesses on the ground that it is incompetent, irrelevant and immaterial, and particularly on the grounds of objections stated in detail to the questions and answers propounded to and given by the witnesses.

"MR. SHOUP: That is understood."

MR. BUCK: I will now read the redirect-examination of Mr. Lincoln:

"TESTIMONY OF MR. LINCOLN:

335 "REDIRECT-EXAMINATION BY MR. SHOUP:

"I have testified that in preparing Exhibit G, some of the accounts appearing in the journal and ledger were omitted. I omitted all Asset Accounts and all Liability Accounts. Speaking generally the accounts omitted represent the investment in the property and the capital issues against same. The accounts included in Statement G shows all the earnings of such investment."

MR. MATTHEWS: I will now read the remainder of his deposition:

376 **"By 'earnings' I do not mean to include mere advances in value of capital assets. I did not include in 'G' any unearned increment on real estate of the Central Pacific Company or any appreciation in value of equipment or other assets."**

MR. MATTHEWS: If your Honor please, I now move to strike out all the exhibits and all the testimony on the basis of the last two answers made by Mr. Lincoln, in which he

Angus D. McDonald—Direct.

admitted an increase in the value of the capital property of the Central Pacific Company. 337

MR. BUCK: That had nothing whatever to do with the earnings of the company. Manifestly we cannot change our earnings based on the fluctuations in the value of property. This is a question of whether or not certain dividends of the Central Pacific Company were paid out of surplus, and the directors when they paid the dividend did not estimate the entire value of the railway properties. They are governed by income of the company.

THE COURT: Yes. Is that all the proof?

MR. BUCK: I would like to call one witness, the Controller of the Company. 338

THE COURT: Your motion made a moment ago, Mr. Matthews, I deny and give you an exception.

ANGUS D. McDONALD, a witness called on behalf of the Plaintiff, being first duly sworn, testified as follows:

DIRECT-EXAMINATION BY MR. BUCK:

My name is Angus Daniel McDonald; and my address is 165 Broadway. I am a railroad official, Vice-President and Controller of the Southern Pacific Company. I am one of the Vice-Presidents and also Controller of the Central Pacific Railway Company. I was elected to that position with the Central Pacific some time in the Spring of 1913, and prior to that time I was Auditor of the Southern Pacific Company and the Central Pacific 339

Angus D. McDonald—Direct.

340 Railway Company, appointed to that position in January, 1910. Prior to that time I was connected with the Southern Pacific. The Central Pacific owned stock in the following companies on June 30, 1914: Coos Bay Oregon Coal Company, the Ogden Union Railway & Depot Company, the Sacramento Transportation Company, the Rubicon Water & Power Company, the McNally Ditch Company, and Newport News & Mississippi Valley Company.

It owned these stocks during each of the fiscal years ending June 30, 1910, to June 30, 1914, both included. It owned no other stocks during those years.

341 The operations of the Sacramento Transportation Company resulted in a net debit to surplus for the year 1914. There was a small surplus, I think, about thirteen hundred dollars for the year 1913.

The result of the entire operations of this Company from the beginning up to the end of the year 1914 was a surplus of about three hundred thousand dollars, a little less than that amount. I think about two hundred and ninety-five thousand dollars.

342 Referring to the other five companies that I have named as companies in which the Central Pacific Railway Company owned stock, their operations, for the five years I have named, did not result in any net surplus for any one of those years. With the exception of the Sacramento Transportation Company, the operations of none of those companies from the time of their incorporation up to and including the end of the year 1914, resulted

Angus D. McDonald—Cross.

in a net credit to surplus. All of them had 343
deficits.

MR. BUCK: Mr. Matthews states that while the evidence shows that we have credited to the Central Pacific Railway Company's income dividends received by the companies in which it owns stock, we have not taken into account their undistributed earnings, and I want to show that the companies in which it has stock, have this one trifling amount of \$295,000. of undistributed earnings.

CROSS-EXAMINATION BY MR. MATTHEWS:

344

I am Vice-President and Controller of the Southern Pacific Company. I have been employed by that Company for about sixteen years and an officer for about nine years. I was auditor of the Southern Pacific Company from January, 1910, down until January, 1914. I know the corporations in which the Southern Pacific Company owns stock in a general way. I never attempted to carry those things in my memory, of course. If you will allow me to read from one of the annual reports of the Southern Pacific Company, I can give you those. The Southern Pacific Company owns the 345
entire capital stock, exclusive of a few shares to directors, of the following:

The Arizona Eastern Railway Company; Central Pacific Railway Company; Galveston, Harrisburg & San Antonio Railway Company; Houston, East & West Texas Railway Company; Houston & Shreveport Railway Company; Houston & Texas Central Railway Company; Louisiana Western R. R. Co.; Morgan's Louisiana & Texas R. R. & S. S.

Angus D. McDonald—Cross.

- 346 Co.; Oregon & California R. R. Co.; South Pacific Coast Ry. Co.; Southern Pacific R. R. Co.; Southern Pacific Terminal Co.; Texas & New Orleans R. R. Co.; Albion Lumber Co.; Beaver Hill Coal Co.; Colusa & Hamilton R. R. Co.; East Coast Oil Co.; Fresno City Ry. Co.; Fresno Traction Co.; Hanford & Summit Lake R. R. Co.; Inter-California Ry. Co.; Kern Trading & Oil Co.; Lake Charles & Northern R. R. Co.; Lincoln Northern Ry. Co.; Mojave & Bakersfield R. R. Co.; Oroville & Nelson R. R. Co.; Pacific Electric Ry. Co.; Peninsular Ry. Co.; Portersville Northeastern Ry. Co.; Rifled Pipe Co., Rockaway Pacific Corporation; Rio Bravo Oil Co.; San Jose Railroads; San Jose & Santa Clara County R. R. Co.; Southern Pacific Land Co.; Southern Pacific R. R. Co. of Mexico; Southern Pacific Building Co.; Stockton Electric Ry. Co.; Sunset Development Co.; Texas Town Lot Co.; Tucson & Nogales R. R. Co.; Visalia Electric R. R. Co.

I think that is substantially all the companies in which the Southern Pacific owns practically all the stock.

The Southern Pacific owns a portion of the stock of the following:

- 348 The Associated Oil Company, the Southern Pacific owns about 51 per cent. of the stock of that company; the Northwestern Pacific R. R. Company, the Southern Pacific owns 50 per cent. of the stock of that company; the Pacific Fruit Express Company, the Southern Pacific owns 50 per cent. of the stock of that company. I think those are the principal companies. I should have included in my previous answer the Independent and Mon-

Angus D. McDonald—Cross.

mouth Railway Company, in which the Southern Pacific owns about 51 per cent. of the stock. The Southern Pacific owns small amounts of stock as follows: 340

The Anaheim Union Water Company, 1 share; The Cucamonga Water Company, 40 shares; the Huntington Land & Townsite Company, stock of the par value of \$3,333.33; the Imperial Water Company, 6 shares; Louisiana Sugar Exchange, 1 share; Meeks & Daley Water Company, 2 shares; North Truckee Ditch Company, stock of the par value of \$1,097; the United States Rail Company, stock of the par value of \$635. 350

The Southern Pacific also owns stocks in small amounts in various other companies which are not detailed in this report here; and I do not recall what others, what those other companies are at the present time.

The amount of stocks of other affiliated companies, not detailed, amounts to \$852,470.00, par value; stocks of other companies not affiliated with the Southern Pacific System in any way, \$64,444.44.

The figures that I have given apply as of June 30, 1914, so that all of the stocks in the corporations mentioned were owned by the Southern Pacific Company during the first six months of 1914. 351

MR. BUCK: If your Honor please, I understood Mr. Matthews was asking these questions to test the memory of the witness. May I ask him now to state the purpose of the examination.

MR. MATTHEWS: The witness was called for the purpose of showing that certain subsidiary

Angus D. McDonald—Cross.

352

companies of the Central Pacific Company had accrued no surplus during the period here in question that could in any appreciable extent be considered earnings or additions to the surplus of the Central Pacific Company.

Now, I have asked the witness to give us the names of the corporations other than the Central Pacific Company, in which the Southern Pacific Company owned stock.

353

Mr. Buck wants to treat earnings when accrued by these various corporations, particularly the Central Pacific Company, as accruing at that time not only to the earning corporation, but likewise, as far as the Southern Pacific owns stock, to the Southern Pacific Company.

If that is true, and he excludes dividends paid that were not paid out of current earnings, he should then include income as earned, whether distributive or not, during the taxing period. Otherwise, we will have a rule that won't work both ways.

354

MR. BUCK: I have included testimony with regard to the earnings of the Central Pacific Railway Company, but I object to any testimony and move to strike out any testimony with regard to the earnings of the Southern Pacific Company which it may equitably be entitled to from its subsidiaries.

The question here being income of the Central Pacific Railway Company and not income of the Southern Pacific Company.

THE COURT: This suit here is for specific income, so confine yourself to that.

MR. MATTHEWS: I think not, your Honor.

 Angus D. McDonald—Cross.

He is suing on the assumption that the portion received from the Central Pacific Company was not income, and I think we are entitled to go into income to the Southern Pacific Company. 355

THE COURT: As to any sources of revenue?

MR. MATTHEWS: Certainly. I think it is further competent evidence to show that the Southern Pacific Company, in making up its income tax return, excluded the dividends received, but failed——

THE COURT: Well, that question is not here.

MR. MATTHEWS: I think it is. It is exactly the question here. 356

The corporations always contend, as they have always under the old law, that they should get their taxes back both coming and going.

THE COURT: I think he is suing here to recover and if he must succeed at all, it must be on the theory that levies were made and taxes collected on this income.

MR. BUCK: Mr. Matthews has not raised any such issue in the pleadings.

MR. MATTHEWS: It is raised in the Southern Pacific's pleadings.

MR. BUCK: Moreover, the complaint is against the Collector as an individual, and he is trying to offset it as—— 357

MR. MATTHEWS: If the Collector was entitled to recover that much cash from the Southern Pacific Company, it makes no difference whether the income arose from this particular dividend, or arose from another dividend.

Angus D. McDonald—Cross.

358

THE COURT: You would have to treat that as an offset then?

MR. MATTHEWS: I think not. The assessment is not on these particular dividends, but on so much income from the Southern Pacific Company. The assessment is made not on dividend as a dividend, but on income to certain amounts, to a certain amount, it is an amount equal to the dividend. As I have stipulated with Mr. Buck, it is not on dividends but on an amount of income equal to the amount of certain dividends.

359

THE COURT: Well, I will deny your motion to strike it out.

MR. BUCK: Exception. Will it be understood that my objection applies to this line of examination?

THE COURT: Yes.

MR. BUCK: And that I take an exception?

THE COURT: Yes.

360

I supervised or directed the preparation of returns of the net income of the Southern Pacific Company for the six months ended June 30, 1914. In that return I did not include income that had accrued to the subsidiary corporations named and the others in which we owned stock, but which had not been distributed to the Southern Pacific Company as dividends. I made an investigation to ascertain the amounts of surplus accruing to these various corporations during that period which had not been distributed to the Southern Pacific Company.

Q. For the purpose of making up your income tax return?

Angus D. McDonald—Cross.

MR. BUCK: Objected to. This is not proper cross-examination, and I move to strike it out, your Honor. 361

THE COURT: Objection overruled. Motion denied.

MR. BUCK: Exception.

I did not make that investigation for the purpose of my return. I cannot without consulting our record state from my investigation the amount of surplus that had accrued to each of those corporations during that period that was not distributed.

MR. MATTHEWS: I ask that the record be produced and the figures read in evidence. 362

MR. BUCK: We are willing to do that, your Honor, if the Government will pay for it.

THE WITNESS: I think I can produce that, produce a statement with so—accumulated surplus as of June 30, 1914. That would merely mean taking a balance sheet of a corporation and take the surplus that appears on that balance sheet.

MR. BUCK: For each company the Southern Pacific owns stock in?

MR. MATTHEWS: I want the surplus earned during that period but not distributed to the Southern Pacific Company, during that period. 363

THE WITNESS: That would complicate the situation very much, when you say surplus earned; that would require an investigation of the surplus and the profit and loss account to ascertain what is included therein.

THE COURT: If you had that, Mr. Matthews

Angus D. McDonald—Cross.

364 —you claim this is only a dividend when it is declared.

MR. MATTHEWS: Yes, and I want to show the Southern Pacific Company acted on that theory itself; and that theory in making up their income tax return was the theory that the Government now—

MR. BUCK: We admit right now and agree with Mr. Matthews that the Government cannot tax us on a dividend that has not been distributed.

THE COURT: I do not think that is material as to the Government.

365

MR. MATTHEWS: If the Southern Pacific Company's theory is sustained, which I do not concede is correct, I think this evidence should be in the record as tending to wipe out or certainly reduce, as the case may be, the recovery.

THE COURT: Can you furnish that to us?

THE WITNESS: Not as he desires it, no. As I understand his question, he wants a statement of the amounts, including any surplus represented by earnings of the company. The books of these various companies are kept all over the United States, and we only keep the books of the Southern Pacific Company in New York City. The records of some of these companies are in Texas, Louisiana, New Mexico, Arizona, California, and Nevada, and we will have to consult the records to make such a statement as he wants.

366

MR. MATTHEWS: If your Honor please, I think with that there is a failure of proof un-

Angus D. McDonald—Cross.

der their own theory, that a verdict should be directed against them. 367

MR. BUCK: We will take that risk as to failure, and subject to my objection we will furnish that evidence.

THE COURT: The question before me now is, to order that statement produced, and I cannot do that.

MR. MATTHEWS: It is incumbent upon them to produce it. They are the plaintiffs here and it is incumbent upon them to produce it.

MR. BUCK: We accept that risk.

MR. MATTHEWS: Then I note my exception on the record to your Honor's failure to direct them to produce it. 368

THE COURT: Yes. I don't know of any rule of law, Mr. Matthews, that requires me to compel the production of any such papers. If the defendant wishes it, it may take the testimony and procure it in the regular way.

MR. MATTHEWS: The defendant does not consider this testimony material to its case, but is offering it merely to show the inconsistent position which the plaintiff has taken, and contends and will contend that without it there is a failure of proof, as far as the plaintiff is concerned. 369

THE COURT: That is something which must be——

MR. BUCK: On the admission of the defendant's attorney, that this is not material, I renew my motion to strike it all out.

THE COURT: Motion denied.

MR. BUCK: Exception.

Angus D. McDonald—Cross.

370 MR. MATTHEWS: My statement that it is not material is based on the theory of the defendant, but it is material if plaintiff's theory is sustained.

I did not include in the income tax return of the Southern Pacific Company surplus earned and accrued to the various corporations in which the Southern Pacific owned stock during the six months period ended June 30, 1914, which was not actually distributed in dividends to the Southern Pacific Company. The accounting regulations of the Interstate Commerce Commission prohibit the making of
371 such entries on the books of the Southern Pacific Company. I did not make any efforts to ascertain the amount of such earnings for the purpose of preparing our income tax statement.

Q. As a matter of accounting, the dividends in question here paid by the Central Pacific Company to the Southern Pacific Company, were treated by the Southern Pacific Company on its books as income, were they not? A. My recollection is that they were credited direct to profit and loss and not to income. They were treated as a profit.

372 There has been testimony that the accounts between the Southern Pacific Company and the Central Pacific Company were such that no distinction was made between the funds of the two companies. A very careful and accurate record was kept of the accounts of the two companies so that you could ascertain to the cent the money to the credit of the Central Pacific Company and the money to the credit of the Southern Pacific Company. On all balances owing by the Central Pacific Company to the Southern Pacific Company interest was figured.

Angus D. McDonald—Cross.

Q. That was true as to the dividends here in 373
question, was it not?

A. By that do you mean that interest was figured
on dividends?

Q. After they were declared and paid, so-called?

A. Those dividends merely had the effect of re-
ducing the book accounts of the two companies.
They had the effect of reducing the indebtedness
of the Southern Pacific Company to the Central
Pacific Company. From the time they were entered
on the books, interest on that indebtedness was
reduced proportionately. Before these dividends
were declared no interest was figured on the sur-
plus of the Central Pacific Company which the 374
Southern Pacific Company was entitled to on dis-
tribution. Interest is figured on book accounts be-
tween the two companies. No interest is figured
on surplus in any way whatever. As soon as those
dividends were declared and entered in the book
accounts, then they went into the accounts upon
which interest is figured, and proportionately
changed the amount of interest. Interest has always
been figured between the two companies, that is,
the Southern Pacific Company has paid the Central
Pacific Company interest on any moneys that they
had loaned the Southern Pacific Company. At the 375
time the Southern Pacific Company received these
dividends from the Central Pacific Company it had
the effect of reducing the amount of indebtedness
between the two corporations, and there is, there-
fore, a corresponding reduction in the amount of
interest.

Q. The Southern Pacific Company did not con-
sider that this surplus before it had been distri-

Angus D. McDonald—Redirect.

376 buted constituted an offset to the Central Pacific Company, did it?

A. It did not consider it by making any entry on its books. The Southern Pacific Company controlled or owned the entire capital stock of the Central Pacific Company and could take that surplus any time it desired to do so. The Boards of Directors were separate and distinct from each other. One Board of Directors did not control the other. Each operated independently of the other.

Q. So that you are wrong, are you not, in stating that the Southern Pacific Company could have distributed this dividend to itself any time it desired?

377 A. I may be wrong in saying that it could do that at any time they desired to do so, but if they had had a Board of Directors in there that would not distribute it when they were asked to do so, they would have put in a Board of Directors that would do so. The Board of Directors of the Central Pacific Company was elected for the term of one year, I think. We might have to wait a year then before they could distribute it.

I am familiar with the earnings and surplus figures of the Central Pacific Company for the years of 1909 to 1914 inclusive, in a general way.

378

REDIRECT-EXAMINATION BY MR. BUCK:

The Interstate Commerce Commission would not have permitted me to include in the Southern Pacific's income the undistributed earnings of companies in which the Southern Pacific owned stock.

MR. BUCK: I offer in evidence that portion of the Interstate Commerce Commission's accounting series, circular No. 12-E, issued

Angus D. McDonald—Redirect.

to railway accounting officers, the portion marked, "Case 537", appearing on pages 3 and 4 of the pamphlet, and ask that it be marked Plaintiff's Exhibit 2-J. 379

THE COURT: All right.

Pamphlet last above referred to, entitled Circular No. 12-E, marked Plaintiff's Exhibit 2-J.

MR. MATTHEWS: I do not object on the ground that it is not a proper copy——

THE COURT: I suppose you will admit that that is a provision of the Interstate Commerce Commission? 380

MR. MATTHEWS: Yes, sir.

MR. BUCK: This is in the form of questions and answers. I will read it:

"Case 537.

"Query 1. To what account should be charged special taxes assessed on the property of a carrier for the cost of the construction of public improvements——

"(a) When the property is used for operating purposes? 381

"(b) When the property is not used for operating purposes, such property having been purchased in order to obtain right of way and carried temporarily in the road and equipment accounts?

"Answer 1. (a) When the improvements benefit the carrier in the operation or maintenance of its property, such taxes should be charged to Additions and Betterments; if there

Angus D. McDonald—Redirect.

382

be no such benefit, they should be charged to Operating Expenses.

(b) To the extent that such improvements add to the value of the carrier's property the taxes should be charged to the account in which the cost of the property is included. The remainder of the assessments should be charged to the income account to which the income from the property is creditable."

MR. MATTHEWS: I understand he offers only the portion of the pamphlet which he has read, being Case No. 537, "a" and "b", on page 3.

383

MR. BUCK: Yes.

MR. MATTHEWS: And I object to it.

THE COURT: Well, I will exclude the whole thing.

MR. BUCK: I want to show, as they kept their books in accordance with the Interstate Commerce Commission's directions, what those instructions were.

THE COURT: Yes. You have shown that the books were kept in accordance with the Interstate Commerce Commission's Accounting Regulations; but I do not think you may show what those rules were in a specific case.

384

MR. BUCK: Exception.

MR. MATTHEWS: I think under the Interstate Commerce Commission's rules there are so many options with respect to charges of depreciation and capitalizing taxes, charging off of discounts on bonds, etc., that without a very clear statement on each of those items the figures offered in evidence have no real meaning, and to that extent they are confusing

Angus D. McDonald—Redirect.

and misleading, and should not be accepted as *prima facie* evidence, even of the facts they purport to represent. I think they should bring witnesses who know something about the operation of the Central Pacific Company and not merely bookkeepers who have made entries and as they are directed to make them. 385

THE COURT: The law is well settled that they may prove it by their books.

MR. MATTHEWS: It is all right when they overcome the objection by proper proof, and we have objected. Now, Exhibit G, there they have a depreciation charge which certainly did not accrue within that year. 386

MR. BUCK: The evidence is that \$2,900,000 of it accrued prior to 1909. Further, it also shows that while that did not accrue subsequent to 1909, there were a great many other credits with which we had enlarged our income over those five years, and the company's credits over debits was three millions of dollars, so we gave the Government the benefit of the three millions of dollars, instead of prejudicing them in any way.

MR. MATTHEWS: These items of bond discount they have charged off on one day, or one year, whereas they should run over, or rather run for that period of thirty-five years; and there are items of interest— 387

THE COURT: It was paid on the day they secured the loan.

MR. MATTHEWS: It may not all be paid.

MR. BUCK: We showed both ways. In the exhibits kept in accordance with the Inter-

Thomas H. McDannel—Direct.

788

state Commerce Commission's regulations, we show the discount at the time the bonds were sold. When a bond is sold the entire liability is taken up on the corporate books—a liability for one thousand dollars, and if it is sold for nine hundred dollars, we credit ourselves with nine hundred dollars and show a discount or loss of one hundred dollars.

THE COURT: You debit yourselves with one hundred dollars?

MR. BUCK: Yes, sir.

389

MR. MATTHEWS: If your Honor please, I would like to call Mr. Thomas H. McDannel.

THE COURT: Very well.

THOMAS H. McDANNEL, a witness called on behalf of the Government, being first duly sworn, testified as follows:

DIRECT-EXAMINATION BY MR. MATTHEWS:

390

I am an Internal Revenue Agent. I am assigned to the Income Tax Bureau, to make examinations and report on corporation books and individual books, for the purpose of ascertaining if the income tax returns rendered by them have been correctly returned. I had occasion to investigate some figures in connection with the Southern Pacific claim in this case. I secured from the Southern Pacific Company certain figures relating to their income and to the income of the Central Pacific Company,—their balance sheets, from the balance sheets of the Southern Pacific and the subsidiary companies. Those balance sheets were furnished

Thomas H. McDannel—Direct.

me by the Southern Pacific's office in this City; the 391
Controller's office. From the data which I got
from the Southern Pacific's office; I did not get the
data from the Southern Pacific's office within the
last week, but when this suit was brought, I went
there to make a rigid examination, and to get addi-
tional figures, and I made an examination at that
time.

BY MR. BUCK:

I saw these records at the office of the Southern
Pacific Company a year ago after the payment of 392
the tax, after the payment had been made, as I
remember. I was not in this district at that time,
and they directed that I come in and get the figures;
and I went with Mr. Taylor (another Internal
Revenue Examiner) to the Southern Pacific Com-
pany's office and we were given all the information
for which we asked.

MR. MATTHEWS: My position at this time is
this: If the theory of the plaintiff is sustained
I think I am entitled to have a decision on the
facts as submitted, whether they show or do
not show surplus as claimed by the plaintiff; 393
that the Government should be entitled to re-
duce the amount claimed in so far as the evi-
dence might show it possible, and that would
be a question of fact.

I am perfectly willing to move for the di-
rection of a verdict so far as the principal ques-
tion or questions in the case is concerned.

Of course, I want to save all rights on behalf

Thomas H. McDannel—Direct.

394

of the defendant so that in any event the losing party may take the proper appeal.

THE COURT: You move for the direction of a verdict and you submit those questions of fact and I will take the place of the jury in determining those questions of fact. If you prefer, however, to have the jury pass on them, I think they can do so.

MR. MATTHEWS: I would rather have you go into them, go into those questions of fact.

THE COURT: All right.

395

MR. MATTHEWS: I now move, your Honor, to strike out all the testimony of the witnesses that has anything whatever to do with the sources of dividends paid by the Central Pacific Company to the Southern Pacific Company; also to strike out all the exhibits relating to corporate books as showing the sources of such dividends.

I also move to strike out all the testimony because it is incompetent, irrelevant and immaterial, and on all the grounds stated in detail to the testimony as it was admitted.

THE COURT: I will reserve my decision on those motions.

396

MR. MATTHEWS: Exception.

MR. BUCK: Exception.

MR. MATTHEWS: I move to dismiss the complaint on all the evidence because the evidence does not prove a cause of action against this defendant; because the complaint does not state facts sufficient to constitute a cause of action; and for the reason that there has been a failure of proof on the part of the plaintiff,

Thomas H. McDannel—Direct.

and the burden resting upon him has not been borne, and for that reason the defendant is entitled to have the case dismissed. 397

THE COURT: Well, I will reserve decision on that motion.

MR. MATTHEWS: I except. I also move for the direction of a verdict in favor of the defendant upon all the grounds stated in my objections to the admission of the testimony and the exhibits, and on all the grounds stated in my motions to dismiss.

THE COURT: Yes. Decision reserved.

MR. MATTHEWS: I except. 398

MR. BUCK: I except to reservation of decision. If your Honor please, I now move that a verdict be directed for the plaintiff for the sum of \$183,615.97, being the amount of a tax, paid by the plaintiff under protest on August 13, 1915, which the defendant claimed the right to collect under the terms of the Act of Congress entitled, "An Act to reduce tariff duties and provide revenue for the Government, and for other purposes", approved October 3, 1913. (I shall hereafter refer to this statute as the "Act".) The tax in question was imposed on the items more particularly described in paragraph Twelfth, subdivisions 1, 2, 3 and 5 of the amended complaint. This motion for direction of verdict for the plaintiff is made upon the following grounds, viz.: 399

1. The undisputed evidence shows that the plaintiff is entitled to recover the tax paid by it under protest on August 13, 1915, upon four dividends aggregating \$18,361,597.43, received

Thomas H. McDannel—Direct.

400

by it from the Central Pacific Railway Company, such tax amounting to the sum of \$183,615.97, and also to recover interest thereon at the rate of six per cent. per annum from August 13, 1915.

401

2. The undisputed evidence shows that such dividends were paid by the Central Pacific Railway Company out of a surplus accumulated by the latter Company prior to the adoption of the Sixteenth Amendment to the Constitution of the United States, and prior to the 1st day of July, 1912, and even prior to the 1st day of July, 1909.

3. It has been twice decided by the United States Circuit Court of Appeals for the 8th Circuit that the Act does not impose a tax on dividends paid from a surplus so accumulated.

4. The Act by its terms should not be construed as imposing a tax on such dividends.

5. Statutes imposing taxes must be strictly construed against the Government and in favor of the taxpayer.

409

6. The Act must not be given a retroactive construction.

7. That such dividends are not taxable under the terms of the Act is shown by the statutes *in pari materia* and decisions thereunder; also by the decisions with respect to life tenant and remainderman holding that a dividend constitutes capital, if paid from surplus accrued prior to the establishment of the trust.

8. Inequality and hardship would result from the construction of the law contended for

Thomas H. McDannel—Direct.

by the defendant, and such a construction 403
should be avoided. Moreover, the spirit of the
Act as a tax on "net income" should prevail.

9. The undisputed evidence shows that the
plaintiff has owned the entire capital stock of
the Central Pacific Railway Company since
the latter's organization in the year 1899, and
during that entire period the plaintiff has
acted as the banker of the Railway Company,
and has also operated its railroads and appur-
tenant properties under lease. The plaintiff
was, therefore, in possession of the moneys and
other assets of the Central Pacific Railway 404
Company long prior to the declaration of the
dividends in question, and the fiction of cor-
porate entity should be disregarded.

10. To give the Act the construction con-
tended for by the defendant would also render
it repugnant to the Constitution of the United
States, for the following reasons, among others,
viz:

(a) A direct tax would be imposed with-
out the apportionment required by the Con-
stitution of the United States (Article I, 405
Section 2, third clause, as amended by Four-
teenth Amendment; and Article I, Section
9, fourth clause).

(b) The tax would be imposed on capital,
and not on income, and, therefore, would
not be exempted by the Sixteenth Amend-
ment to the Constitution of the United
States from the apportionment so required.

Thomas H. McDannel—Direct.

406 The Sixteenth Amendment must not be given a retroactive construction.

(c) The tax would be so unequal in operation as to result in the deprivation of property without due process of law, and as to constitute the taking of private property for public use without just compensation, in contravention of the Fifth Amendment to the Constitution of the United States; and such a construction would also make the act contravene the implied limitations upon the taxing powers of Congress.

407 11. The Act should be so construed as to avoid raising any constitutional question.

THE COURT: Is that all.

MR. BUCK: I am waiting for your Honor to rule on my motion.

THE COURT: Decision reserved.

MR. BUCK: Exception.

408 In the event that you deny the motion that I have just made, I make the same motion separately for the direction of a verdict for the amount of tax paid on each of the three dividends received by the Southern Pacific Company from the Central Pacific Railway Company in January, 1914, and on so much of the dividend received by the Southern Pacific Company from the Central Pacific Railway Company in June, 1914, as was paid out of surplus accruing prior to January 1, 1913, the motion in each case being made upon the grounds heretofore stated.

I also move that the verdict include interest

Thomas H. McDannel—Direct.

at the rate of six per cent. per annum from 409
August 13, 1915, the date upon which the tax
was paid, to the date of the entry of judgment
herein.

In conclusion, the undisputed evidence
shows that the plaintiff acted under duress in
paying the tax which is here sought to be re-
covered, and that it has taken the proper steps
to authorize such recovery. The undisputed
evidence further shows that at least \$3,915,-
448.48 of the dividends upon which the tax
was imposed had been paid from the proceeds
of sale of capital assets, and for this addi- 410
tional reason the plaintiff is entitled to re-
cover the tax on so much of the said dividends
as were paid out of the said proceeds of sale.

I, therefore, ask that this reason be added
as an additional ground upon which the mo-
tions heretofore made for a directed verdict
shall be based to the extent of the said sum of
\$3,915,448.48.

THE COURT: Very well. I will reserve my
decision on your motions.

MR. BUCK: Exception.

THE COURT: Now you have two causes of
action and I think that the record should show 411
that the first—

MR. BUCK: There is a stipulation on file in
the Clerk's office, but if your Honor thinks it
is not a part of the record in this case and that
it is necessary to offer this stipulation in evi-
dence, I suppose Mr. Matthews will offer no
objection to allowing that to be received.

Thomas H. McDannel—Direct.

412 THE COURT: I direct the jury to find a verdict for the defendant.

MR. BUCK: Exception. Does your Honor deny each of my several motions for the direction of a verdict for the plaintiff.

THE COURT: Yes.

MR. BUCK: I except to the denial of each of such motions.

Thereupon the jury returned a verdict for the defendant as directed by the Court.

413 The foregoing and the copy or statement of the exhibits hereto annexed constitute all the evidence introduced and offered upon the trial of this cause.

Plaintiff's Exhibit 2-A.**Form 1082.**

THE PENALTY for failure to have this Return in the hands of the Collector of Internal Revenue on or before March 1, or within 60 days after the close of the fiscal year, is a sum not exceeding \$10,000.

UNITED STATES INTERNAL REVENUE.**RETURN OF ANNUAL NET INCOME.**

(Section 2, Act of Congress approved October 3, 1913.)

June 1915 List

P. 4, L. 10

Rev. Agt. Sinsel

5/20/15

Add assessment

PUBLIC SERVICE CORPORATIONS.

RETURN OF NET INCOME received during the six months of the fiscal year ended June 30, 1914, by Southern Pacific Company the principal place of business of which is located for the purpose of this return at # 165 Broadway, City or Town of New York, in the State of New York.

This return being subject to the attached memorandum which is made a part thereof.

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

1. Total amount of paid-up capital stock outstanding at close of the year, or if no capital stock, the capital employed in the business at the close of the year..... \$272,672,405.64
2. Total amount of bonded and other indebtedness outstanding at close of year..... \$206,233,910.00

-
3. GROSS INCOME (see Note A)..... 49,715,313.95
\$30,444,420.44

DEDUCTIONS.

4. (a) Total amount of all the ordinary and necessary expenses paid within the six months in the maintenance and operation of the business and properties of the corporation, EXCLUSIVE OF INTEREST PAYMENTS. (See Note B)..... 3,781,063.15
\$3,732,008.92
- (b) All rentals or other payments required to be made as a condition to the continued use or possession of the property..... \$ 12,500.00
5. (a) Total amount of losses sustained during the six months not compensated by insurance or otherwise..... \$1,140,714.66
- (b) Total amount of depreciation for the six months \$ 465,912.11

Plaintiff's Exhibit 2-A.

6. (a) Total amount of interest accrued and paid within the six months on an amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the six months on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year	\$4,684,256.91
(b) Total amount of interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions.....	\$
7. (a) Total taxes paid during the year, imposed under authority of the United States or any State or Territory thereof.....	\$ 98,874.72
Reserved from surplus for insurance reserve....	\$1,000,000.00 <i>suspended*</i>
(b) Foreign taxes paid.....	\$
	11,183,341.55
TOTAL DEDUCTIONS	<u>\$11,184,266.72</u>
Add tax 192,218.19	
8. Net income on which tax at 1 per centum is calculated.....	\$ 19,310,153.72
	<u>1,000,000*</u>
	<u>20,310,153.72*</u>
	39,531,972.40

*Note—The word and figures italicized were added by United States Treasury Department officials in blue lead pencil.

Plaintiff's Exhibit 2-A.

STATE OF NEW YORK, County of New York, TO WIT:

A. D. McDONALD, Vice-President, and A. K. VAN DEVENTER, Treasurer of the Southern Pacific Company, a corporation, whose return of net income for six months is set forth above, being severally duly sworn, each for himself, deposes and says that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the six months stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed.

SWORN AND SUBSCRIBED to before me this 29th day of September, 1914

A. D. McDONALD
Vice-President.

.....
SEAL OF
OFFICER
TAKING
AFFIDAVIT.
.....

W. C. WARNE
Notary Public Kings County No. 129
Certificate filed in New York County No. 45

A. K. VAN DEVENTER
Treasurer.

NOTE A.—Gross income shall consist of the total revenues derived from the operation and management of its business and properties together with all amounts of income from other sources, including dividends received on stock of other organizations, whether subject to this tax or not, and interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions, as shown by entries upon its books during the year for which return is made.

NOTE B.—The deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered upon its books during the year. Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to capital account, should not be deducted in ascertaining annual net income. Interest paid on mortgage indebtedness on real estate occupied or used by a corporation may be deducted under Item 4, if the interest is paid as rental or franchise charge, payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in Item 4 should be stated separately under Item 4 (b).

The return of Southern Pacific Co. was amended, as shown in red ink, in accordance with the provisions of paragraph (C), subsection G, of section 2 of the act of Congress approved October 3, 1913.

DAVID A. GATES
Acting Commissioner.

July 30, 1915.

The following note was appended to this return, viz.:

Extraordinary dividends received, which have been paid out of surplus accumulated prior to January 1, 1913, have been excluded.

[In view of stipulation between the parties, the accompanying protest is omitted.]

Plaintiff's Exhibit 2-B.

[Written on official letterhead of Commissioner of Internal Revenue, and dated Washington, May 15, 1915.]

SOUTHERN PACIFIC Co.,
165 Broadway, New York.

GENTLEMEN:—

You are informed that this office is in receipt of a report submitted by Internal Revenue Agent John W. Sinsel covering an examination of the books of your company for the years 1913 and 1914, as a result of which examination he recommends additional assessment of income tax as follows—

For the year 1913.....	\$132,961.14
“ “ “ 1914.....	192,395.81

It appears that you have been informed as to the basis upon which these proposed assessments are to be made. The principal item involved in each year is that of dividends which you received from other corporations but which you omitted from your gross income in the returns filed in this office.

In this connection your attention is called to Treasury Decision 2163 which clearly sets out the attitude of this office as to such dividends and how they shall be treated in returns of annual net income.

The other items going to make up the aggregate amount of additional tax recommended to be assessed have been correctly treated by the examining officers.

Plaintiff's Exhibit 2-C.

You are therefore informed that this office approves the recommendation of Revenue Agent Sinsel and respectfully requests that you prepare and file with Mr. Sinsel, amended returns accounting for the additional income in accordance with the regulations of this Department.

Respectfully,

W. H. OSBORN,
Commissioner.

Plaintiff's Exhibit 2-C.

is a printed brief submitted to Commissioner of Internal Revenue in opposition to the assessment of the additional tax which this action was brought to recover.

[In view of the stipulation between the parties, this brief is omitted.]

Plaintiff's Exhibit 2-D.**NOTICE OF AND DEMAND FOR TAX
ASSESSED.**

AUGUST 4, 1915.

**SOUTHERN PACIFIC COMPANY,
New York City.**

You are hereby notified that a tax, under the Internal Revenue Laws of the United States, amounting to \$192,218.19, the same being a tax upon Net Income for the period ending June 30, 1914, has been assessed against you by the Commissioner of Internal Revenue and transmitted by him to me for collection.

Demand is hereby made for this tax, which is due and payable to the person designated below on or before August 14, 1915. If this tax is not in my hands for deposit before the close of business of the day above specified, it will become my duty, under the law, to collect the same together with five per centum additional, and interest at one per centum per month until paid.

Signed by JOHN Z. LOWE, JR.,
United States Collector of Internal
Revenue, Second District of
New York.

Endorsed "Paid under protest." and further
endorsed: "Received payment Internal Revenue
2nd Dis. New York

Aug. 13, 1915.
\$192,218.19."

[In view of stipulation between the parties, the
accompanying protest is omitted.]

Plaintiff's Exhibit 2-E.

On the reverse side of the foregoing notice and demand the following endorsement is printed, viz.:

To avoid penalty and interest, taxes must be paid to the Collector or person designated by him in such a manner as will enable him to place the same with his depository and receive a certificate of deposit therefor not later than the close of business on the date mentioned in the body of this notice.

Plaintiff's Exhibit 2-E.

Form 46.

Claim Under Series 7, No. 14, Revised, and Series 7, No. 27, Supplement No. 1, for Taxes Improperly Paid, or Refundable Under Remedial Statutes and for Amounts Paid for Stamps Used in Error or Excess.

U. S. INTERNAL REVENUE.

STATE OF NEW YORK }
County of New York } ss:

ANGUS D. McDONALD of 165 Broadway, City of New York and State and County aforesaid, being duly sworn according to law, deposes and says, that he is a vice-president and controller of the Southern Pacific Company, a Kentucky corporation, engaged in the business of operating railroads and steamships, that on or about the 4th day of August, A. D. 1915, the said Company was assessed an internal-revenue tax of One hundred ninety-two thousand two hundred eighteen and $\frac{19}{100}$ (192,218.19) dollars, on net income for six months ending June 30, 1914, under the Act entitled "An Act to reduce tariff duties and provide revenue for the Government and for other purposes," approved

Plaintiff's Exhibit 2-E.

October 3, 1913, which amount it afterwards, on the 13th day of August, A. D. 1915, paid to John Z. Lowe, Jr., Esq., Collector of Internal Revenue for the 2nd District of New York, and which amount, as this deponent verily believes, should be refunded for the following reasons, viz:

See "Exhibit A" attached to second page following.

[In view of stipulation between the parties the attached Exhibit is omitted.]

And this deponent now claims that, by reason of the payment of the said sum of \$192,218.19 the said Southern Pacific Company is justly entitled to have the sum of One hundred eighty-three thousand eight hundred eighty-two and $\frac{14}{100}$ (183,882.64) dollars refunded, and it now asks and demands the same.

And this deponent further makes oath that the said claimant is not indebted to the United States in any amount whatever, and that no claim has heretofore been presented for the refunding of the above amount, or any part thereof, except the sum of \$177.62 mentioned in said "Exhibit A" as the tax on the cost of the Clark Oil Company's stock.

A. D. McDONALD.

Sworn to and subscribed }
before me this 13th day }
of August, A. D. 1915. }

WM. E. LA PLANTE
Notary Public
New York County

[SEAL]

Endorsed by Committee on claims of Treasury Department: "Examined and rejection approved."

Plaintiff's Exhibit 2-F

was a letter dated October 15, 1915, from G. E. Fletcher, acting Commissioner of Internal Revenue, denying the plaintiff's claim for refund (Plaintiff's Exhibit 2-E).

Plaintiff's Exhibit 2-G.

is a stipulation and is hereinbefore set forth in full.

Plaintiff's Exhibit 2-H.

SOUTHERN PACIFIC COMPANY

Statement of dividends received during the six months ended June 30, 1914, segregated between dividends received which were reported in the return of annual net income, as being taxable under the Federal Income Tax Law, and those which were not.

Name of company from which the dividend was received	Total amount of dividend	Amount included in return	Amount excluded from return
Albion Lumber Co.—Annual dividend.....	\$45,000.00	\$45,000.00	.....
Associated Oil Co.—6 months dividend paid June 30, 1914.....	301,035.00	301,035.00	.....
Central Pacific Ry. Co.:			
Annual dividend on common stock, from which has been excluded the amount paid in excess of the company's earnings.....	4,036,530.00	3,124,032.52	\$912,497.48
Preferred stock dividend paid June 30, 1914.....	522,000.00	522,000.00	.....
Extraordinary dividend of 20% on common stock.....	13,455,100.00	.....	13,455,100.00
Extraordinary dividend of 20% on preferred stock.....	3,480,000.00	.....	3,480,000.00
Extraordinary dividends paid from proceeds received from Rockaway Pacific Co.:			
Paid on Common Stock.....	408,373.00	.....	408,373.00
Paid on Preferred Stock.....	105,637.00	.....	105,637.00
Houston & Shreveport R. R. Co.—regular dividend.....	119,280.00	119,280.00	.....
Kern Trading & Oil Co.—regular dividend.....	2,100,000.00	2,100,000.00	.....
Louisiana Western Ry. Co.—regular dividend.....	336,000.00	336,000.00	.....
Pacific Fruit Express Co.—regular dividend.....	540,000.00	540,000.00	.....
Revard Oil Co.:			
Dividend received in June, 1914, in excess of the regular monthly dividend was paid out of surplus and therefore considered an extraordinary dividend.....	51,111.09	24,444.45	26,666.64
Rified Pipe Co.—regular dividend.....	12,400.00	12,400.00	.....
Rio Brave Oil Co.—regular dividend.....	254,820.00	254,820.00	.....
San Bernardino & Redlands R. R. Co.—Regular dividend.....	4,500.00	4,500.00	.....
Southern Pacific Building Co.—regular dividend.....	23,970.00	23,970.00	.....
Southern Pacific R. R. Co.—regular dividend.....	9,600,000.00	9,600,000.00	.....
Southern Pacific Terminal Co.—regular dividend.....	119,976.00	119,976.00	.....
Texas Town Lot Co.—regular dividend.....	3,940.00	3,940.00	.....
United States Rail Co.—regular dividend.....	15.88	15.88	.....

Plaintiff's Exhibit 2-I.

[Entitled in this action.]

IT IS HEREBY STIPULATED AND AGREED by and between the parties hereto that the objection heretofore made in the taking of testimony at San Francisco, California, in the above entitled action, to Exhibits A, B, C, and D, on the ground that such exhibits were copies and not originals, is hereby waived and the defendant stipulates that he will not object to the said exhibits upon the ground that they are copies and not originals, provided however that the defendant reserves the right to object to said exhibits on any other ground.

IT IS ALSO STIPULATED AND AGREED by and between the parties hereto that the objection heretofore made to Exhibits G, K, L, N and Q on the ground that they were copies and not originals is hereby waived, and the defendant stipulates that he will not object to said exhibits on the ground that they are copies and not originals, provided however that the defendant reserves the right to object to said exhibits on the ground that they are not complete or correct copies and on any other ground stated.

Dated, New York, October 11, 1916.

GORDON M. BUCK,

Attorney for Plaintiff.

H. SNOWDEN MARSHALL,

Attorney for Defendant.

Plaintiff's Exhibit 2-J.

is an extract from the Accounting Regulations of the Interstate Commerce Commission. This extract is hereinbefore set forth in full.

Plaintiff's Exhibit A.

CENTRAL PACIFIC RAILWAY COMPANY

**RESOLUTION ADOPTED BY BOARD OF DIRECTORS,
DECEMBER 29, 1913.**

On motion, duly made and seconded, it was unanimously

RESOLVED that an extra dividend of twenty per cent. payable out of earnings accumulated prior to January 1, 1913, is hereby declared upon the outstanding preferred capital stock of this, the Central Pacific Railway Company, payable on January 10, 1914, to stockholders of record at close of business on January 9, 1914.

Plaintiff's Exhibit B.

CENTRAL PACIFIC RAILWAY COMPANY

**RESOLUTION ADOPTED BY BOARD OF DIRECTORS,
DECEMBER 29, 1913.**

On motion, duly made and seconded, it was unanimously

RESOLVED that an extra dividend of twenty per cent. payable out of earnings accumulated prior to January 1, 1913, is hereby declared upon the outstanding common capital stock of this, the Central Pacific Railway Company, payable on January 10, 1914, to stockholders of record at close of business on January 9, 1914.

Plaintiff's Exhibit C.**CENTRAL PACIFIC RAILWAY COMPANY****RESOLUTIONS ADOPTED BY BOARD OF DIRECTORS,
DECEMBER 23, 1913**

The President stated that some years ago this Company had acquired in satisfaction of debt the property comprising the westerly end of Rockaway Point on the south shore of Long Island, New York; that the legal title to this property was held by Mr. Andrew K. Van Deventer, but that the beneficial ownership was in this company; that the Southern Pacific Company have caused to be organized under the laws of the State of Delaware a corporation known as the Rockaway Pacific Corporation for the purpose of acquiring the property above mentioned; that the Rockaway Pacific Corporation desired to purchase the said property for the sum of \$514,000; and that as the Southern Pacific Company owned the capital stock of this company, as well as of the Rockaway Pacific Corporation, he recommended that the sale be made and that the purchase price so received by this Company be declared as a dividend.

On motion, duly seconded, it was unanimously

RESOLVED (1) That the sale of said Rockaway Point property to the Rockaway Pacific Corporation for the sum of \$514,000 is hereby authorized and approved, and that Mr. Andrew K. Van Deventer and wife are hereby requested to convey the said property to the said Rockaway Pacific Corporation.

RESOLVED (2) That the said sum of \$514,000 is hereby declared as a dividend payable January 2, 1914, *pro rata* on the stock (both preferred and common) of this Company to stockholders of record at the close of business on December 27, 1913.

Plaintiff's Exhibit D.**CENTRAL PACIFIC RAILWAY COMPANY**

**RESOLUTION ADOPTED BY BOARD OF DIRECTORS,
JUNE 13, 1914.**

RESOLVED that a Dividend (No. 17) of Six Per Cent. be and the same is hereby declared upon the outstanding Common Capital Stock of this, the Central Pacific Railway Company, payable on June 13, 1914, to stockholders of record at close of business on June 12, 1914.

Plaintiff's Exhibit E.

**AMENDMENT TO LEASE BETWEEN CEN-
TRAL PACIFIC RAILROAD COMPANY
AND SOUTHERN PACIFIC COMPANY.**

THIS INDENTURE, made and entered into this seventh day of December, eighteen hundred and ninety three, by and between the CENTRAL PACIFIC RAILROAD COMPANY of the first part and the SOUTHERN PACIFIC COMPANY of the second part.

WHEREAS, heretofore and under date of the 17th day of February, 1885, an agreement of lease was made and entered into by and between the parties hereto, which agreement of lease was afterwards modified by agreement between the same parties bearing date the first day of January, 1888; and

WHEREAS, the operation of the demised properties under such lease has resulted in very considerable losses to the said Southern Pacific Com-

Plaintiff's Exhibit E.

pany, and it thereby appears that by the operation of said agreement the said Central Pacific Railroad Company has been and is being benefited at the expense of the Southern Pacific Company, and a necessity has therefore arisen for a revision and change of such lease so that neither party thereto shall be benefited at the expense of the other;

NOW, THEREFORE, THIS INSTRUMENT WITNESSETH:
That in consideration of the premises such agreement of lease has been and is hereby revised and changed by the parties hereto by substituting on and after the first day of January, 1894, for the existing provisions of such lease, as so modified as aforesaid, the terms, provisions, and conditions hereinafter provided and expressed, that is to say:

FIRST. The party of the first part hereby leases to the party of the second part for the period of ninety years from and including the first day of January next, the railroads of the party of the first part, together with its branches and leased lines, and all depots and station houses, equipments, and appurtenances of every kind and nature whatsoever to the said railroads, branches, and leased lines respectively belonging or appertaining.

SECOND. The party of the second part will pay to the party of the first part a fixed yearly rental for the premises so leased, amounting to the sum of ten thousand dollars per annum, which rental shall be paid in four equal installments of twenty-five hundred dollars each on the first days of January, April, July and October of each year during the pendency of this lease (excepting only the first

Plaintiff's Exhibit E.

day of January, eighteen hundred and ninety-four), it being understood and agreed that the amount of such rental so far as requisite shall be appropriated and applied by the party of the first part to the expenses of maintaining and keeping up its corporate organization.

THIRD. The party of the second part is to operate the said railroads, branches, and leased lines hereinbefore referred to. The said lessee shall apply the earnings and income derived therefrom to paying all operating expenses thereof and the incidental expenses connected therewith, including the sums payable for rentals of leased lines, and, according to their lawful priorities, to the payment of the current interest and sinking fund contributions or other payments from time to time becoming due and payable from the said Central Pacific Railroad Company, whether to the United States of America or to bondholders or others, during the existence of this lease.

And it is further provided and agreed by and between the parties hereto that on the first day of April in each year during the continuance of this lease the party of the second part shall pay to the party of the first part such balance, if any, of the net earnings or income received by the party of the second part from the said leased premises, with the appurtenances, for the year ending on the 31st day of December then next preceding, as shall remain in its hands after all the payments hereinbefore provided for or agreed or directed are made: *Provided, however,* That if at the time, viz., such 1st day of April, when such balance of such income or rental is provided to be paid to the party of the first part, there shall be any sum due or owing from the party of the first part to the party

Plaintiff's Exhibit E.

of the second part for or in respect of advances or payments theretofore made by the party of the second part to or for or upon the request of the party of the first part for new additions or improvements to the demised premises, or any part thereof, or for expenses of keeping up the corporate organization of the party of the first part, or maintaining agencies for the transfer of its stock and bonds, or for any expenses of its business or affairs other than such as fall within the payments before provided to be made by the lessee out of the earnings or income, or for or in respect of any other sums which may have been lawfully advanced or paid by the lessee to or for the party of the first part, the party of the second part shall be entitled to retain and pay to itself whatever may be owing to it from the party of the first part for or in respect of any of the causes or matters or considerations aforesaid, including any interest which may be due or owing from the party of the first part to the party of the second part thereon.

And provided further, That if such balance of net earnings or income received by the party of the second part from the said leased premises, with the appurtenances, for any year, and which by the foregoing provisions hereof would be and become payable by said party of the second part to said party of the first part, shall exceed the amount of six per cent. per annum upon the par value of the then existing capital stock of the party of the first part, then and in that event the said party of the second part shall be entitled to and shall retain to itself for its own use one-half part of any and all excess of such balance of net earnings and income over and above the amount of six per cent. per an-

Plaintiff's Exhibit E.

num upon the par value of the then existing capital stock of the party of the first part.

FOURTH. If and so far as the party of the second part shall make any advances for payments, for account of the party of the first part, the party of the second part shall be entitled to receive interest upon all such advances at the rate of six per cent. per annum from the making until the reimbursement thereof, and the party of the second part shall have a lien for such advances, and the interest thereon, upon the said demised premises and the income thereof until such advances are reimbursed, with interest; and the party of the second part shall be entitled at any time and from time to time to refund to itself such advances and interest out of any net earnings or income of the demised premises which may be in its hands, unless it shall have been expressly agreed between the parties hereto to the contrary, in writing, at or before the making of such advances.

FIFTH. The agreements between the same parties dated February 17, 1885, and January 1, 1888, respectively, are hereby cancelled, except so far as they relate to operation of said demised premises prior to January 1, 1894, and adjustment of accounts in respect to such operation thereof.

SIXTH. This indenture may be at any time modified in any of its terms or provisions or cancelled by agreement of the parties thereto.

IN WITNESS WHEREOF the parties hereto have hereunto respectively affixed their corporate seals and caused these presents to be signed by their respec-

Plaintiff's Exhibit E.

tive presidents and attested by their respective secretaries the day and year first above written.

CENTRAL PACIFIC RAILROAD COMPANY,
By H. E. HUNTINGTON,

[SEAL]

President.

Attest:

W. M. THOMPSON,
Secretary.

SOUTHERN PACIFIC COMPANY,
By C. P. HUNTINGTON,

[SEAL]

President.

Attest:

G. L. LANSING,
Secretary.

BETWEEN CENTRAL PACIFIC RAILROAD
COMPANY AND SOUTHERN PACIFIC
COMPANY.

AGREEMENT.

INDENTURE made and entered into this twenty-second day of March, 1894, by and between CENTRAL PACIFIC RAILROAD COMPANY, of the first part, and the SOUTHERN PACIFIC COMPANY, of the second part.

WHEREAS heretofore and under date of the 7th day of December, 1893, an indenture was made and entered into by and between the parties hereto, revising and changing the then existing agreement of lease between said parties, as by said indenture,

Plaintiff's Exhibit E.

dated the 7th day of December, 1893, by reference thereto will fully and at large appear; and

WHEREAS it has been suggested, on behalf of the Central Pacific Railroad Company, that such last-mentioned indenture should be modified as hereinafter provided, and the Southern Pacific Company has assented to such proposed modification thereof;

NOW, THEREFORE, THIS INDENTURE WITNESSETH: That in consideration of the premises the parties hereto have undertaken, covenanted, and agreed, and do hereby undertake, covenant, and agree, to and with each other as follows, viz.:

FIRST. The said indenture, dated the 7th day of December, 1893, is hereby modified by substituting in lieu of article fourth of said indenture the following article, that is to say:

FOURTH. If and so far as the party of the second part shall make any advances for payments for account of the party of the first part, the party of the second part shall be entitled to receive lawful interest upon all such advances from the making until the reimbursement thereof, and the party of the second part shall be entitled at any time and from time to time to refund to itself such advances and interest out of any net earnings or income of the demised premises which may be in its hands, unless it shall have been expressly agreed between the parties hereto to the contrary in writing at or before the making of such advances.

And it is further agreed between said Central Pacific Railroad Company and said

Plaintiff's Exhibit E.

Southern Pacific Company that if at any time it appears that by the operation of this agreement either party is being benefited at the expense of the other, then this agreement shall be revised and changed so that such will not be the operation thereof, and if the parties hereto cannot agree upon the changes necessary to that end, then each party shall appoint one arbitrator, disinterested, but skilled in relation to the subject-matter, and the award and decision of such arbitrators in writing shall be binding upon the parties hereto, and this agreement shall be revised and changed in accordance with such award and decision, and, as revised and changed, shall be duly executed in writing by the parties hereto.

And it is further agreed that if the arbitrators so chosen cannot agree upon an award and decision, then that the two shall choose a third impartial and skilled arbitrator, and that the award and decision of two of said three arbitrators shall have the same force and effect between the parties hereto, and shall be executed in like manner as hereinbefore provided for the award and decision of the two arbitrators first chosen.

SECOND. The said indenture, dated the 7th day of December, 1893, as so modified by the first article hereof, is hereby in all respects ratified, approved, and confirmed.

IN WITNESS WHEREOF the parties hereto have hereunto respectively affixed their corporate seals

159

Plaintiff's Exhibit E

and caused these presents to be signed by their respective presidents and attested by their respective secretaries the day and year first above written.

CENTRAL PACIFIC RAILROAD COMPANY,
By ISAAC L. REQUA,
President.

(C. P. R. R. Co.
CORPORATE SEAL)

Attest:

W. M. THOMPSON,
Secretary.

SOUTHERN PACIFIC COMPANY,
By C. P. HUNTINGTON,
President.

(S. P. Co. CORPORATE SEAL)

Attest:

G. L. LANSING,
Secretary.

THIS AGREEMENT, made and entered into this 15th day of April, A. D., 1897, by and between the CENTRAL PACIFIC RAILROAD COMPANY, of the first part, and the SOUTHERN PACIFIC COMPANY, of the second part,

WITNESSETH:

THAT WHEREAS, under existing arrangements between the parties hereto, it has been the practice

Plaintiff's Exhibit E.

that on the first day of April in each year while operating the railroad of the party of the first part, the party of the second part should pay to the party of the first part such balance of income or earnings of the railroad, with the appurtenances, received by the party of the second part for the year ending on the 31st day of December, then next preceding, as should remain in the hands of the party of the second part after the deduction of certain charges and expenses.

AND WHEREAS, it is to the convenience of both of said parties to change the dates of said accountings and settlements so as to conform to the reports required by the Interstate Commerce Commission and other governmental bodies and officers, by adopting as the basis therefor a fiscal year ending June 30th of each year, instead of December 31st;

NOW, THEREFORE, it is hereby agreed by and between the parties hereto that hereafter all said balances shall be paid on the first day of November of each year, and shall be for and on account of the year ending on the 30th day of June then next preceding, except that in the first settlement which shall be made under this agreement, to-wit: that of November 1st, 1897, such settlement shall be made upon an accounting for the whole period from January 1st, 1896, to June 30th, 1897, both days inclusive.

IN WITNESS WHEREOF, the said parties have caused these presents to be signed by their respective Presi-

Plaintiff's Exhibit E.

dents or Vice-Presidents, and secretaries, under their several corporate seals, the day and year first above written.

CENTRAL PACIFIC RAILROAD COMPANY,

By **ISAAC L. REQUA,**

[CORPORATE SEAL]

President.

W. M. THOMPSON,

Secretary.

SOUTHERN PACIFIC COMPANY,

By **C. P. HUNTINGTON,**

[CORPORATE SEAL]

President.

E. C. WRIGHT,

Secretary

Plaintiff's Exhibit F.

CENTRAL PACIFIC RAILWAY COMPANY.

LIST OF STOCKHOLDERS

SEPTEMBER 1, 1916.

COMMON STOCK

Name	Cert. No.	Date of Certificate	No. of Shares
T. O. Edwards.....	64	Feb. 16, 1914.....	1
Wm. F. Herrin.....	45	May 15, 1909.....	1
William Hood.....	66	Nov. 9, 1914.....	1
G. L. King.....	61	April 1, 1913.....	1
E. O. McCormick....	53	Jan. 12, 1911.....	1
C. H. Redington....	42	June 25, 1907.....	1
T. F. Rowlands.....	59	Feb. 1, 1913.....	1
W. R. Scott.....	44	May 15, 1909.....	1
Wm. Sproule.....	68	July 11, 1913.....	1
Southern Pacific Com- pany.....	9	Sept. 25, 1899..	672,707
	36	Jan. 17, 1906..	85
	65	Apr. 14, 1914..	1
	67	Nov. 9, 1914...	3
Total.....			672,746
			672,755

PREFERRED STOCK

Name	Cert. No.	Date of Certificate	No. of Shares
Southern Pacific Com- pany.....	2	Sept. 25, 1899.....	120,000
	3	July 16, 1902..	4,000
	4	Nov. 21, 1902.....	2,000
	5	Oct. 8, 1903.....	2,000
	6	Oct. 7, 1904.....	2,000
	7	Oct. 10, 1905.....	2,000
	8	Oct. 29, 1906.....	2,000
	9	Jan. 21, 1908.....	2,000
	10	Oct. 12, 1908.....	2,000
	11	Oct. 2, 1909.....	2,000
	12	June 9, 1910.....	30,000
	13	January 25, 1911.....	2,000
	14	November 23, 1911....	2,000
Total.....			174,000

Plaintiff's Exhibit G.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT OF INCOME FOR THE FISCAL YEARS ENDED JUNE 30, 1910 TO JUNE 30, 1914, BOTH INCLUSIVE

	Year Ended June 30, 1910	Year Ended June 30, 1911	Year Ended June 30, 1912	Year Ended June 30, 1913	Year Ended June 30, 1914	Total
By Rentals for Joint tracks, yards & other facilities—Prop. Cos.....	47,030.47	72,554.40	58,875.04	58,060.28	58,060.28	294,570.47
" Rentals for Joint tracks, yards & other facilities—Outside Cos.....	31,186.34	43,700.10	64,968.25	64,181.22	63,072.49	269,078.30
" Rentals for lease of road—Prop. Cos.....	60,000.00	60,000.00	116,156.00	60,000.00	60,000.00	356,156.00
" Gross Revenue Transportation.....	33,184,233.05	30,761,460.20	30,268,426.28	34,370,837.52	32,874,433.04	161,459,369.09
" " " Operations other than Transportation.....	269,122.55	224,482.55	215,245.66			698,964.77
" " " Outside Operations.....	1,577,046.63	1,586,645.66	1,614,650.00			4,778,342.35
" Rental from So. Pac. Co.....	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	50,000.00
" Income from lands covered by 3-1/2% mortgage.....	86,132.90	83,378.32	112,070.18	151,942.11	183,409.14	616,932.65
" " " securities.....	485,740.69	481,887.80	310,807.01	310,935.84	260,563.76	1,849,435.10
" " " Sacramento Rolling-Mill plant.....	8,319.12	8,319.12	8,614.31	8,478.44	8,483.60	42,209.59
" " " Ogden Hotel.....	4,107.29	3,968.85	1,523.59			9,599.73
" Privileges to cross right of way.....	2,920.00	301.00	664.65	3,515.61	4,781.56	18,182.82
" Proceeds from sales of lands in Alameda Co.....	719.88					719.88
" C. P. Ry. interest in Wells Fargo & Co. contract.....	32,000.00	32,000.00	32,000.00	32,000.00	32,000.00	160,000.00
" Interest discount and exchange.....	74.32	40,615.09	30,867.11	7,486.56	30,028.72	118,071.80
" " " special.....	158,910.72	164,787.23	1,277,108.98	1,395,857.71	725,357.14	3,722,016.78
" Rentals—Other properties (Lands at Rockaway Beach).....	372.00	2,051.00	7,510.00	7,500.00	1,617.45	19,050.45
" Rentals for lease of road—Outside Cos.....			17,705.83	34,720.68		52,426.49
" Hire of Equipment—Operating Offices.....			49,346.44	78,083.87	225,699.49	354,069.80
" Outside property rentals.....			500.00			500.00
" Income from sinking fund investments.....				8,796.10	21,868.11	30,664.21
" Interest on bonds owned—Prop. Cos.....				8,150.00	8,150.00	16,300.00
" Rental from Butte County R. R. Co.....				52,081.00	52,081.00	104,162.00
" " " Southern Pacific R. R. Co.....				168,488.00	172,477.08	340,965.08
" Income from Miscellaneous Physical Properties.....					17,101.67	17,101.67
" Miscellaneous income.....					4.00	4.00
GROSS INCOME.....	35,948,988.87	33,584,651.33	34,197,154.42	36,831,989.92	34,811,177.53	175,373,912.06
DEDUCTIONS FROM GROSS INCOME						
To Rental for lease of road—S. P. Co.....	90,442.56					90,442.56
" " " " —Secondary Cos.....	210,048.27	492,490.53	337,290.43			1,039,829.23
" " " " —Outside Cos.....	21,664.52	28,068.52	21,949.74	65,855.59	26,617.82	164,171.19
" Hire of Equipment.....	614,240.97	564,889.37	897,878.40	966,540.74	952,558.34	4,016,157.82
" Operating Expenses.....	18,314,571.27	17,770,830.75	17,308,594.22	30,520,091.66	20,006,155.02	93,917,242.87
" Outside Operations—Expenses.....	1,492,437.73	1,563,136.76	1,567,170.27			4,622,744.76
" Taxes.....	1,221,330.56	1,195,831.22	1,464,491.59	1,558,291.04	1,662,950.08	7,292,394.46
" S. P. Co's 1/3 of net profits under lease.....	1,804,325.41	484,896.18				2,289,221.59
" Interest on 3-1/2% bonds.....	508,092.82	532,567.47	469,746.78	442,520.20	416,971.57	2,438,506.84
" Interest on funded debt.....	4,376,043.46	4,744,368.93	6,062,223.16	7,710,261.24	7,700,241.90	31,302,157.69
" Land Department expenses.....	72,710.30	82,998.79	122,763.71	108,246.15	110,618.96	499,333.78
" " " Taxes.....	193,684.18	208,202.22	277,695.84	254,051.74	286,272.72	1,315,037.40
" General Expenses.....	7,364.08	6,378.59	7,106.64	8,245.24	7,971.30	37,666.89
" Sinking fund contributions.....	50,000.00	50,000.00	50,000.00			150,000.00
" Expenses—Other properties.....	2,301.00	1,415.25	480.00	2,007.46	680.00	6,883.71
" Taxes—Other properties.....	3,951.05	6,617.04	11,251.33	11,281.94	2,645.50	25,716.86
" Rentals for Joint tracks, yards and other facilities—Prop. Cos.....		32,576.00	44,400.00	44,679.15	44,628.32	156,273.47
" Rentals for Joint tracks, yards and other facilities—Outside Cos.....		4,809.44	7,615.51	12,522.08	32,781.81	57,712.84
" Rentals for Joint tracks, yards and other facilities—S. P. Co.....		90,442.56	9,000.00	19,000.00	19,000.00	137,442.56
" Proceeds from sale of lands in Alameda Co.—(Net).....		1,265.44	1,899.20	2,068.71	2,740.04	7,982.39
" Interest on Extension Notes.....			202,787.00	608,860.97	608,860.96	1,419,508.93
" Sinking fund requirements and earnings.....			1,000.00	1,000.00	1,000.00	3,000.00
" Sinking fund contributions and income from sinking fund investments.....				58,796.10	71,068.11	130,064.21
" Income from Miscellaneous Physical Properties.....					720.76	720.76
TOTAL DEDUCTIONS FROM GROSS INCOME.....	32,342,236.99	27,845,410.76	29,425,545.23	22,414,788.08	21,150,783.16	150,909,772.61
Net Income.....	3,606,751.88	5,739,240.56	4,771,609.19	4,417,201.84	3,660,394.37	24,464,139.25

Plaintiff's Exhibit G.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT OF PROFIT AND LOSS FOR THE FISCAL YEARS ENDED JUNE 30, 1910, TO JUNE 30, 1914, BOTH INCLUSIVE

CREDIT	Year Ended June 30, 1910	Year Ended June 30, 1911	Year Ended June 30, 1912	Year Ended June 30, 1913	Year Ended June 30, 1914	TOTAL
Credit balance—June 30, 1909.....	25,260,361.91	27,997,608.20	22,950,450.38	24,042,751.50	22,082,468.36	.....
By discount on Preferred Stock issued to S. P. Co. to March 31, 1908 credited back.....	141,000.00					141,000.00
" Restatement of leasehold operations, years 1906/8.....	99,064.27					99,064.27
" Quit claim deed to lots in Bay View Homestead Assn. Tract, San Francisco.....	25.00					25.00
" Discount on C. P. Ry. First Refunding 4's purchased & cancelled.....	686.25					686.25
" Discount on C. P. Ry. 3-1/2% bonds purchased & cancelled.....	24,411.48	206,519.66	61,213.40	66,478.27	76,500.98	487,222.79
" Proceeds from sales of lands covered by 3-1/2% mtge.....	153,301.93	295,569.12	250,943.50	326,665.80	402,347.08	1,428,827.43
" Sinking fund contributions and earnings.....	50,006.80	66,350.68	65,443.70	59,796.10	72,868.11	314,466.89
" Balance from Income above.....	6,906,711.83	5,738,240.56	4,741,560.60	4,417,201.84	3,660,424.37	24,464,139.25
" Material recovered from spur track (Winnemucca).....		225.74				225.74
" Proportion of amounts charged C. P. R. R. Co. through leasehold operations during years 1878 to 1898 on account of Thurman Act requirements. Credited back.....		701,252.22				701,252.22
" Rentals collected during January to April 1907 incl. by S. P. Co. from property in Sacramento.....			1,467.50			1,467.50
" Interest accrued prior to July 1, 1911 on securities depos- ited against bonds satisfied of mortgage.....			12,258.33			12,258.33
713 M. C. P. Ry. 4's.....	11,883.83					
25 M. S. P. Broh. 6's.....	575.00					
" Interest accrued prior to July 1, 1911 on securities depos- ited with United States Trust Co. of New York against 3-1/2% bonds outstanding.....			94,006.66			94,006.66
" 2 shares of McNally Ditch Co. stock acquired from Nevada & California Ry. Co.			1.00			1.00
" Expenditures during fiscal years ended June 30, 1900 and June 30, 1901 for addition & betterments and for equip- ment, transferred to Capital Expenditures.....			2,209,898.80			2,209,898.80
" Adjustment of interest on 3-1/2% bonds Sept. 1912.....				29.17		29.17
" Adjustment of Leasehold settlements with S. P. Co. years June 30, 1906 to June 30, 1911 both inclusive.....				954,018.81		954,018.81
" Interest on advances, from beginning to June 30, 1912 which Ogden U. Ry. & D. Co. charged to Capital Ac- count.....				76,045.73		76,045.73
To Income Acct.....	5,424.73					
	70,620.96					
" Interest on \$163,000 face value, bonds of Ogden U. Ry. & D. Co. to June 30, 1912.....				153,491.66		153,491.66
" Difference between cost on books and proceeds from sale of Rockaway Beach property.....					281,674.33	281,674.33
" Adjustment of interest on 3-1/2% bonds.....					16.04	16.04
" Mission Bay State Grant transferred.....					2,301,500.00	2,301,500.00
" Rental of property in San Francisco, sold S. P. Co. in Oc- tober, 1906 to June 30, 1913.....					136,297.23	136,297.23
" Transfer of principal of deferred payments on contracts covering sales of granted lands outsidg. June 30, 1914.....					2,152,982.19	2,152,982.19
" Transfer of expenses paid by French Banks.....					28.61	28.61
TOTAL.....	22,622,571.99	25,955,724.18	28,297,243.97	29,556,479.65	26,279,222.22	24,022,616.95

Plaintiff's Exhibit H.

CENTRAL PACIFIC RAILWAY COMPANY.

1909				
June 30	By Surplus—(as per Ledger).....			\$25,250,361.91
	"Profit & Loss" account.....	\$22,752,449.12		
	"Proceeds from Sales of Lands covered by 3-1/2% Mortgage" account.....		1,972,621.05	
	"Sinking Fund Contributions and Earnings" account.....		525,291.74	
	OK with SPCo. Annual Report for year ended June 30, 1909 (p. 48).....			\$25,250,361.91
1910				
June 30	By total credits to Income during year ended June 30, 1910.....	35,948,988.87		
	Less—total debits—same period...	29,042,226.99		
			6,906,711.88	
	By total credits to Profit & Loss dur- ing same period..	468,497.23		
	Less—total debits—same period.....	35,434.82	433,062.41	
	NET CREDIT TO SURPLUS DURING YEAR.		7,339,774.29	
	Disposition:			
	Dividend 6% on Common Stock....	4,036,530.00		
	Dividends 2% on Preferred Stock..	556,000.00		
		4,592,530.00		
	Balance added to surplus.....	2,747,244.29	2,747,244.29	
1910				
June 30	By surplus—OK with SPCo. Annual Report for year ended June 30, 1910 (p. 47).....			\$27,997,606.20

Plaintiff's Exhibit H.

1910		
June 30	By Surplus.....	27,997,606.20
1911		
June 30	By total credits to Income during year ended June 30, 1911.....	33,584,651.32
	Less—total debits—same period....	27,846,410.76
		<u>5,738,240.56</u>
	By total credits to Profit & Loss during same period. 1,269,917.42	
	Less—total debits— same period.... 4,643,763.80	3,373,846.38
		<u>2,864,994.18</u>
	NET CREDIT TO SURPLUS DURING YEAR.	
		<u>7,411,550.00</u>
	<i>Disposition:</i>	
	Dividend 6% on Common Stock....	4,036,530.00
	Dividend 4% (Extra) " "	2,691,030.00
	Dividends 2% on Preferred Stock...	684,000.00
		<u>7,411,550.00</u>
	Dividends paid in excess of surplus for the year	<u>5,047,155.82</u>
1911		
June 30	By Surplus—OK with SPCo. Annual Report for Year ended June 30, 1911 (p. 49).....	\$22,950,450.88

Plaintiff's Exhibit H.

1911	By surplus		\$22,960,450.88
1912			
June 30	By total credits to Income during year ended June 30, 1912.....	84,197,154.49	
	Less—total debits—same period....	29,455,593.82	
		<u>4,471,560.60</u>	
	By total credits to Profit & Loss dur- ing same period. . 2,695,232.80		
	Less—total debits— same period..... 1,615,902.37	1,079,270.62	
		<u>5,820,831.12</u>	
	NET CREDIT TO SURPLUS DURING YEAR		
	<i>Disposition:</i>		
	Dividend 6% on Common Stock....	4,056,530.00	
	Dividends 2% on Preferred Stock...	692,000.00	
		<u>4,728,530.00</u>	
	Balance added to surplus.....	1,092,301.12	1,092,301.12
1912			
June 30	By surplus—OK with SPCo. Annual Report for year ended June 30, 1912 (p. 53).....		\$24,042,751.50

17. 282,034.1

Plaintiff's Exhibit H.

1913		
June 30	By surplus.....	\$24,042,751.50
1918		
June 30	By total credits to Income during year ended June 30, 1913.	36,831,969.92
	Less total debits—same period.....	32,414,788.08
		<hr/> 4,417,201.84
	By total credits to Profit & Loss dur- ing same period. 1,636,525.54	
	Less—total debits— same period ... 473,485.52	1,163,040.02
		<hr/>
	NET CREDIT TO SURPLUS DURING YEAR.	<hr/> \$5,580,341.86 <hr/>
<i>Disposition:</i>		
	Dividend 6% on Common Stock....	4,066,530.00
	Dividends 2% each (3) on Preferred Stock.....	1,014,000.00
	Dividend (Special) to bring divi- dends on Preferred stock up to 6% same as on Common Stock.....	2,460,000.00
		<hr/> 7,540,530.00
	Dividends paid in excess of surplus for the year.....	<hr/> 1,980,288.14 <hr/>
1918		
June 30	By Surplus—OK with SPCo. Annual Report for year ended June 30, 1918 (p. 49).....	\$22,082,463.36

Plaintiff's Exhibit H.

1913		
June 30	By Surplus.....	\$22,082,463.36
1914		
June 30	By total credits to Income during year ended June 30, 1914....	34,811,177.53
	Less—total debits—same period....	32,150,758.16
		<u>2,660,424.37</u>
	By total credits to Profit & Loss dur- ing same period. 5,527,704.62	
	Less—total debits— same period. 5,420,833.19	106,871.43
		<u>2,767,295.80</u>
	NET CREDIT TO SURPLUS DURING YEAR.	
<i>Disposition:</i>		
	Dividend a/c sale of Rockaway Beach property on Common Stock	406,373.00
	Dividend 20% (Special) on Common Stock.....	13,455,100.00
	Dividend 6% on Common Stock....	4,036,580.00
	Dividends 3% (2) on Preferred Stock.	1,044,000.00
	Dividend (a/c sale of Rockaway Beach property) on Preferred Stock.....	105,627.00
	Dividend 20% (Special) on Preferred Stock.....	3,480,000.00
		<u>22,529,680.00</u>
	Dividends paid in excess of surplus for the year.....	<u>19,762,334.20</u>
1914		
June 30	By surplus—OK with SPCo. Annual Report for year ended June 30, 1914 (p. 43).....	\$3,820,129.16
	Aug. 28, 1916.	

Plaintiff's Exhibit I.**CENTRAL PACIFIC RAILWAY COMPANY.**

Surplus year ending June 30, 1910 after payment of dividends.....	\$2,747,344.29
Deficit year ending June 30, 1911, after payment of dividends.....	5,047,155.82
Balance paid from surplus prior to July 1, 1909.....	2,299,911.53
Surplus year ending June 30, 1912, after payment of dividends.....	1,092,301.12
Balance paid from surplus prior to July 1, 1909 of dividends paid since that date..	1,207,610.41
Deficit year ending June 30, 1913, after payment of dividends.....	1,960,288.14
Balance paid from surplus prior to July 1, 1909—of dividends paid since that date.	3,167,898.55
Deficit year ending June 30, 1914, after payment of dividends.....	12,762,334.20
Balance paid from surplus prior to July 1, 1909 of dividends paid since that date..	\$22,930,232.75
Procc	
1909	
June 30 By Surplus.....	\$25,250,361.91
1914	
June 30 By Surplus.....	2,329,129.16
	<u>\$22,930,232.75</u>
Aug 28 1916	

Plaintiff's Exhibit J.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT SHOWING DEBITS AND CREDIT TO PROFIT AND LOSS
DURING YEARS ENDED JUNE 30, 1910, TO JUNE 30, 1914, BOTH
INCLUSIVE, WHICH COVERED TRANSACTIONS PRIOR TO JULY
1, 1900, VIZ.:

Credits

During year ended June 30, 1910

Discount on preferred stock issued to S. P. Co. to March 31, 1908, credited back.....	\$141,000.00
Restatement of leasehold operations years 1906/08....	90,064.27
	<hr/>
	\$240,064.27

Debits

None

Credits

During year ended June 30, 1911

Adjustment of leasehold operations years 1878 to 1898.	\$701,252.22
--	--------------

Debits

None

Credits

During year ended June 30, 1912

Expenditures during fiscal years ended June 30, 1900, and June 30, 1901, for additions and betterments and for equipment, transferred to Capital Expendi- tures	\$2,209,898.80
--	----------------

Debits

None

Credits

During year ended June 30, 1913

Adjustment of leasehold settlements with S. P. Co., years June 30, 1906, to June 30, 1909, inc., of \$954,- 018.61 to June 30, 1911.....	\$543,018.61
--	--------------

Debits

Rental of certain lands lying between Oakland Pier and Estuary from Jan. 5, 1906, to June 30, 1912— say 1/2 of \$76,608.21, or.....	\$38,304.61
---	-------------

Plaintiff's Exhibit J.

Credits

During year ended June 30, 1914	
Mission Bay State Grant (sold S. P. Co. 1905).....	\$2,301,500.00
Interest on property in San Francisco sold S. P. Co. in Oct., 1905, to June, 1913,—say 1/2 of \$138,297.28.	69,148.64
Proportion of transfer of principal of deferred pay- ments on land contracts outstanding June 30, 1914, of \$2,152,363.19—prior to July 1, 1909.....	10,515.28
	<hr/> 2,381,163.92

Debits

Transfer of premium paid on 2286 M. S. P. Co., 6% Steamship bonds—matured Jan. 1, 1911.....	81,000.75
Depreciation of equipment from date of acquirement to June 30, 1913—\$4,026,213.06 prior to January 1, 1909, (see vo. 745).....	2,943,549.28
	<hr/> 3,025,340.04

SUMMARY

	<i>Dr.</i>	<i>Cr.</i>
During year ended June 30, 1910	.....	240,064.27
" " " June 30, 1911	.....	701,232.22
" " " June 30, 1912	.....	2,209,898.80
" " " June 30, 1913 (approx.)	33,346.61	543,018.81
" " " June 30, 1914	3,025,340.04	2,381,163.92
	<hr/> 3,058,686.65	<hr/> 6,075,308.02
Net Credits..	3,011,511.57	
	<hr/> \$6,075,308.02	

Issued by Accounting Department
San Francisco, Cal., Aug. 23, 1916

Correspondence in relation to this
statement should be addressed to
the Auditor.

Form Q T. 1

Credits.

FOR USE IN COMPILING FEDERAL CORPORATION TAX "RETURN OF ANNUAL NET INCOME" FOR CALENDAR YEAR 1913

(1-24-14-1M-B-159)

See Note	TITLE OF ACCOUNTS	Fiscal Year Ended June 30, 1913.	6 Months Ended December 31, 1912.	6 Months Ended June 30, 1913.	6 Months Ended December 31, 1913.	Total Calendar Year 1913.
1	2	3	4	5	6	7
	INCOME ACCOUNTS—CREDIT					
3	1 Operating Revenues.....					
3	2 Outside Operations—Revenues.....					
3	3 Hospital Department—Revenues.....					
	4					
3	5 Total Operating Revenues.....					
*	6 Total Revenue from Sales of Merchandise or Supplies.....					
*	7 Less:—Cost of Merchandise or Supplies Sold.....					
3	8 Gross Revenue from Sales of Merchandise or Supplies.....					
3	9					
3	10 Rental for Lease of Road.....	220,549.00		220,549.00	112,963.84	332,512.84
3	11 Hire of Equipment—Balance.....					
3	12 Rental from Joint Tracks, Yards and Terminal Facilities.....					
3	13 Miscellaneous Rentals.....	7,500.00		7,500.00	3,957.64	11,457.64
3	14 Miscellaneous Income.....	43,989.05	22,183.24	21,826.31	25,908.39	45,195.20
3	15 Dividends on Stocks Owned.....					
3	16 Income from Sinking Fund Investments.....	8,796.10	6,000.00	2,796.10	7,200.00	9,996.10
3	17 Interest on Bonds Owned.....	8,150.00		8,150.00	4,075.00	12,225.00
3	18 Interest on Loans, Advances and Open Accts. with Prop. and Affil. Cos.....	787,496.74	351,461.61	496,035.13	261,317.50	697,352.73
3	19 Interest, Discount and Exchange.....	7,486.56		7,486.56	9,789.55	17,276.11
3	20 Income from lands & securities not pledged for redemption of bonds.....	462,877.95	190,694.88	272,183.07	180,778.26	452,961.33
	21					
	22					
	23					
	24					
	25					
	26					
	27					
3	28					
3	29 Profits from Leasehold Operations.....	3,306,981.85		3,306,981.85		3,306,981.85
3	30 Rental from Southern Pacific Company.....	10,000.00	5,000.00	5,000.00	5,000.00	10,000.00
						4,306,981.79
	31					
	32					
	33					
	PROFIT AND LOSS—CREDIT					
*	34 Sinking Fund Contributions and Earnings.....	59,796.10	31,600.00	28,296.10	32,700.00	60,996.10
*	35 Proceeds from Sale of Lands Pledged for Redemption of Bonds.....	296,085.30	120,119.12	206,546.68	111,188.62	317,735.30
*	36 Income from Land Trust Fund.....					
*	37 Proceeds from Sale of Unpledged Lands.....					
3	38 Delayed Income Credits, Adjustment Interest Eps.....	15.67		15.67		15.67
3	39 Adjustment of Old Ledger Accounts.....					
3	40 Profit Derived from Sale of Investment Securities.....					
3	41 Profit Derived from Sale of Miscellaneous Real Estate, Railway Beach.....					
3	42 Discount on bonds purchased and cancelled.....	96,478.27	34,622.24	21,254.91	27,415.47	59,370.35
3	43 Readjustment of Leasehold Operations 1906/8 incl.....	406,018.31		406,018.31		406,018.31
3	44 do do 1908/11 incl.....	546,000.00		546,000.00		546,000.00
3	45 Balance—Debit.....					2,574,496.14
	Total.....	6,278,322.90	761,541.21	3,509,241.69	1,180,725.00	9,244,436.52

STATEMENT OF CAPITAL LIABILITIES AND OTHER INTERESTS AS OF DECEMBER 31, 1912.

45 Paid Up Capital Stock Outstanding December 31, 1913

84,675,500.00

Plaintiff's Exhibit K.

Form C. T. 2

Debits.

STATEMENT OF INCOME AND PROFIT AND LOSS OF CENTRAL PACIFIC RAILWAY COMPANY
FOR USE IN COMPILING FEDERAL CORPORATION TAX "RETURN OF ANNUAL NET INCOME" FOR CALENDAR YEAR 1913

(1-24-14-1M-8-153)

See Note	TITLE OF ACCOUNT	Fiscal Year Ended June 30, 1913.	6 Months Ended December 31, 1912	6 Months Ended June 30, 1913.	6 Months Ended December 31, 1912.	Total Calendar Year, 1913.
1	2	3	4	5	6	7
	INCOME ACCOUNTS—DEBIT					
4 (a)	50 Operating Expenses.....					
4 (a)	51 Outside Operations—Expenses.....					
4 (a)	52 Hospital Department—Expenses.....					
	53					
4 (a)	54 Total Operating Expenses.....					
4 (b)	55 Rental for Lease of Road.....					
4 (a)	56 Hire of Equipment—Balance.....					
4 (b)	57 Rental of Joint Tracks, Yards and Terminal Facilities.....					
4 (b)	58 Miscellaneous Rentals.....	12,319.51	4,441.71	7,877.80	5,955.90	14,833.79
4 (a)	59 Miscellaneous Expenses.....	109,246.12	50,599.26	58,646.86	59,815.75	118,462.61
4 (a)	60 Land Department Expenses.....	59,796.10	31,500.00	28,296.10	32,700.00	60,996.10
*	61 Sinking Fund Requirements and Earnings.....					
	62					
	63					
	64					
*	INTEREST:					
*	65 (a) Interest on Funded Debt.....					
*	66 (b) Interest on Cash Advances and Open Accounts with Proprietary and Affiliated Companies.....					
*	67 (c) Interest, Discount and Exchange.....					
*	68 (d)					
*	69 Total Interest.....					
*	70 Less: Interest on an Amount of Funded and Other Indebtedness In Excess of One-Half of the Amount of Paid Up Capital Stock Outstanding and Interest Bearing Indebtedness.....					
6 (a)	71 Interest on an Amount of Funded and Other Indebtedness Not Exceeding One-Half of the Amount of Paid Up Capital Stock Outstanding and Interest Bearing Indebtedness.....					
6 (b)	72 Total Amount of Interest Received upon the Obligations of a State or Political Subdivision thereof, and upon the Obligations of the United States or its Possessions.....					
	73					
	74					
5 (a)	75 Discount on Bonds Sold, European Loan of 1911.....	288,100.22		288,100.22		288,100.22
5 (b)	76 Depreciation.....	265,963.06	127,229.04	157,910.64	134,824.71	272,735.35
7 (a)	77 Taxes—in United States.....					
7 (b)	78 Taxes—in Foreign Countries.....					
						755,156.07
	PROFIT AND LOSS—DEBIT					
4 (a)	79 Commission on Bonds Sold.....	6,472.97	5,262.97	1,210.00		1,210.00
4 (a)	80 Premiums on Stocks and Bonds Redeemed.....					
5 (a)	81 Discount on Stock Extinguished Through Surplus.....					
5 (a)	82 Discount on Bonds Extinguished Through Surplus.....	114,226.14		114,226.14		114,226.14
5 (a)	83 Losses on Road and Equipment Abandoned or Retired.....	44,985.14				
4 (a)	84 Delayed Income Debits.....	75,226.31				
5 (a)	85 Rental land Oakland Pier to Estuary.....	1,966.17	125,226.32	125,226.32	22,065.79	145,292.31
	86 Operation Riverside Electric.....					
5 (a)	87 Uncollectible Accounts Written Off.....					
5 (a)	88 Losses from Sales of Investment Securities.....					
5 (a)	89 Losses from Sale of Miscellaneous Real Estate.....					
	90					
	91					
	92					
	93 Dividends Paid on Preferred Stock.....	2,504,000.00	2,400,000.00	2,150,000.00	637,627.00	2,782,627.00

Profit and Loss—Credit						
34	Sinking Fund Contributions and Earnings.....	59,796.10	31,500.00	23,296.10	33,700.00	60,996.10
35	Proceeds from Sale of Lands Pledged for Redemption of Bonds...	326,665.80	120,119.12	206,546.68	111,188.62	317,735.20
36	Income from Land Trust Fund.....					
37	Proceeds from Sale of Unpledged Lands.....					
38	Delayed Income Credits, Adjustment Interest 3½%.....	16.67		16.67		16.67
39	Adjustment of Old Ledger Accounts.....					
40	Profit Derived from Sale of Investment Securities.....					
41	Profit Derived from Sale of Miscellaneous Real Estate, Hookaway Beach.....				261,674.33	261,674.33
42	Discount on bonds purchased and cancelled.....	66,478.27	34,623.36	31,854.91	27,415.47	59,270.26
43	Readjustment of Leasehold Operations 1906/8 incl.....	408,018.81		408,018.81		408,018.81
44	do 1906/11 incl.....	546,000.00		546,000.00		546,000.00
45	Balance—Debit.....					2,574,496.14
Total.....		6,370,602.90	761,661.21	5,608,941.69	1,160,728.69	9,344,456.82

STATEMENT OF CAPITAL LIABILITIES AND OTHER INDEBTEDNESS AS OF DECEMBER 31, 1913.

1	46	Paid Up Capital Stock Outstanding December 31, 1913.....	34,675,500.00
	47	Funded Debt Outstanding December 31, 1913.....	180,444,548.26
	48	Advances and Other Indebtedness Outstanding December 31, 1913.....	
2	49	Total Funded and Other Indebtedness Outstanding December 31, 1913.....	180,444,548.26

INSTRUCTIONS

- Item 18. Report under this item only Interest on Loans, Advances and on Open Accounts with Proprietary or Affiliated Companies.
 Item 19. Report under this item only Interest on Loans, Advances and on Open Accounts other than with Proprietary and Affiliated Companies.
 Item 48. Report under this item all Loans, Cash Advances, or Open Accounts, on which interest is accrued and charged to Income Account.

Note. In this column is designated the number of the item on Government Form 100, "Return of Annual Net Income," under which the item in Column 3 should be reported. Such items as designated with a star (*) should not be taken up on Government Form 100.

Plaintiff's Exhibit L.

Form C. T. 1

Credits.

STATEMENT OF INCOME AND PROFIT AND LOSS OF CENTRAL PACIFIC RAILWAY COMPANY

FOR USE IN COMPILING FEDERAL CORPORATION TAX "RETURN OF ANNUAL NET INCOME" SIX MONTHS ENDING JUNE 30, 1914

(1-24-14-1M-S-153)

See Note	TITLE OF ACCOUNTS	Fiscal Year Ended June 30, 1914.	6 Months Ended December 31, 1913.	6 Months Ended June 30, 1914.	6 Months Ended December 31, 1913.	Total Calendar Year, 1913.
1	2	3	4	5	6	7
	INCOME ACCOUNTS—CREDIT					
3	1 Operating Revenues.....					
3	2 Outside Operations—Revenues.....					
3	3 Hospital Department—Revenues.....					
4	4					
3	5 Total Operating Revenues.....					
*	6 Total Revenue from Sales of Merchandise or Supplies.....					
*	7 Less—Cost of Merchandise or Supplies Sold.....					
3	8 Gross Revenue from Sales of Merchandise or Supplies.....					
9	9					
3	10 Rental for Lease of Road.....	234,538.06	112,263.84	112,264.24		
3	11 Hire of Equipment—Balance.....					
3	12 Rental from Joint Tracks, Yards and Terminal Facilities.....					
3	13 Miscellaneous Rentals.....	1,617.45	3,957.64	2,340.19		
3	14 Miscellaneous Income.....	49,437.00	33,393.39	17,119.21		
3	15 Dividends on Stocks Owned.....					
3	16 Income from Sinking Fund Investments.....	21,668.11	7,300.00	14,668.11		
3	17 Interest on Bonds Owned.....	5,150.00	4,075.00	4,075.00		
3	18 Interest on Loans, Advances and Open Accts. with Prop. and Asst. Cos.....	116,996.18	261,317.59	144,321.41		
3	19 Interest, Discount and Exchange.....	30,025.72	9,789.55	20,236.17		
3	20 Income from lands and securities not pledged for redemption of bonds.....	442,972.90	189,778.23	253,194.64		
3	21					
3	22					
3	23					
3	24					
3	25					
3	26					
3	27					
3	28 Profits from Leasehold Operations.....	2,246,541.96		2,246,541.96		
3	29 Rental from Southern Pacific Company.....	10,000.00	5,000.00	5,000.00		
31	30			2,256,479.73		
32	31					
33	32					
	PROFIT AND LOSS—CREDIT					
*	34 Sinking Fund Contributions and Earnings.....	72,686.11	32,700.00	49,186.11		
*	35 Proceeds from Sale of Lands Pledged for Redemption of Bonds.....	468,347.00	111,289.48	261,158.48		
*	36 Income from Land Trust Fund.....					
*	37 Proceeds from Sale of Unpledged Lands.....					
3	38 Delayed Income Credits.....					
3	39 Adjustment of Old Ledger Accounts.....	54.05		54.05		
3	40 Interest to 6/30/14 on prop. in S. P. purchased by S.P.Co. in Oct. 1913.....	31,007.47		31,007.47		
3	41 W—Firm.....	37,230.31		37,230.31		
3	42 Profit Derived from Sale of Miscellaneous Real Estate.....	361,074.30	361,074.30	361,074.30		
3	43 Discount on bonds purchased and cancelled.....	78,000.00	27,415.47	51,154.31		
3	44 Balance on land contracts outstanding.....	2,122,222.19		2,122,222.19		
3	45 Mission Bay State Grant.....	2,321,300.00		2,321,300.00		
46	46 Balance—Debit.....			18,713,888.51		
	Total.....	2,971,925.02	1,199,129.00	27,329,779.44		

STATEMENT OF INCOME AND PROFIT AND LOSS OF CENTRAL PACIFIC RAILWAY COMPANY

FOR USE IN COMPILING FEDERAL CORPORATION TAX "RETURN OF ANNUAL NET INCOME" FOR SIX MONTHS ENDING JUNE 30, 1914

(1-24-14-1M-3-100)

See Note	TITLE OF ACCOUNT	Fiscal Year Ended June 30, 1914	6 Months Ended December 31, 1913	6 Months Ended June 30, 1914	6 Months Ended December 31, 1913	Total Calendar Year 1913
1	2	3	4	5	6	7
	INCOME ACCOUNTS—DEBIT					
4 (a)	50 Operating Expenses.....					
4 (a)	51 Outside Operations—Expenses.....					
4 (a)	52 Hospital Department—Expenses.....					
	53					
4 (a)	54 Total Operating Expenses.....					
4 (b)	55 Rental for Lease of Road.....					
4 (a)	56 Hire of Equipment—Balance.....					
4 (b)	57 Rental of Joint Tracks, Yards and Terminal Facilities.....					
4 (b)	58 Miscellaneous Rentals.....					
4 (a)	59 Miscellaneous Expenses.....	8,790.51	6,965.99	1,824.52		
4 (a)	60 Land Department Expenses.....	110,618.96	59,815.75	50,808.21		
	61 Sinking Fund Requirements and Earnings.....	72,808.11	32,700.00	40,168.11		
	62					
	63					
	64					
	INTEREST:					
	65 (a) Interest on Funded Debt.....					
	66 (b) Interest on Cash Advances and Open Accounts with Proprietary and Affiliated Companies.....					
	67 (c) Interest, Discount and Exchange.....					
	68 (d)					
	69 Total Interest.....					
	70 Less: Interest on an Amount of Funded and Other Indebtedness in Excess of One-Half of the Amount of Paid Up Capital Stock Outstanding and Interest Bearing Indebtedness.....					
6 (a)	71 Interest on an Amount of Funded and Other Indebtedness Not Exceeding One-Half of the Amount of Paid Up Capital Stock Outstanding and Interest Bearing Indebtedness.....					
6 (b)	72 Total Amount of Interest Received upon the Obligations of a State or Political Subdivision thereof, and upon the Obligations of the United States or its Possessions.....					
	73					
	74					
5 (a)	75 Discount on Bonds Sold (6 mos. propn.) during period 1913 to 1914 inc.....	66,892.91		66,892.91		
5 (b)	76 Depreciation.....					
7 (a)	77 Taxes—In United States.....	291,519.05	124,624.71	156,694.34		
7 (b)	78 Taxes—In Foreign Countries.....					
				222,293.00		
	PROFIT AND LOSS—DEBIT					
4 (a)	79 Commission on Bonds Sold.....					
4 (a)	80 Premiums on Stocks and Bonds Redemmed.....					
4 (a)	81 Discount on Stock Extinguished Through Surplus.....					
4 (a)	82 Discount on Bonds Extinguished Through Surplus.....					
4 (a)	83 Losses on Road and Equipment Abandoned or Retired.....	389,471.85		389,471.85		
4 (a)	84 Delayed Income Debits.....					
4 (a)	85 Adjustment of Old Ledger Accounts (Add Surveys N. Y. Q. will pay 1197.00).....	22,095.30	22,095.79	1,572.51		
4 (a)	86 Uncollectible Accounts Written Off.....	31,090.78		31,090.78		
4 (a)	87 Losses from Sale of Investment Securities.....	2,943,549.23		2,943,549.23		
4 (a)	88 Losses from Sale of Miscellaneous Real Estate Prior to 1/1/14.....	1,992,092.78		1,992,092.78		
4 (a)	89 Depreciation of Equipment to Jun. 30, 1913 Bal.....	5,998.17		5,998.17		
4 (a)	90 of Planting Equipment to Jun. 30, 1913 Prior 1/1/14.....					
4 (a)	91					
4 (a)	92 Dividends Paid on Preferred Stock.....	4,002,000.00	627,627.00	4,002,000.00		

STATEMENT OF FINANCIAL POSITION

This statement is prepared in accordance with the provisions of the Act of March 3, 1907, as amended.

Assets		Liabilities and Capital	
1. Cash	100.00	1. Cash	100.00
2. Bonds	200.00	2. Bonds	200.00
3. Stocks	300.00	3. Stocks	300.00
4. Real Estate	400.00	4. Real Estate	400.00
5. Other Assets	500.00	5. Other Assets	500.00
6. Total Assets	1,500.00	6. Total Liabilities and Capital	1,500.00
7. Cash	100.00	7. Cash	100.00
8. Bonds	200.00	8. Bonds	200.00
9. Stocks	300.00	9. Stocks	300.00
10. Real Estate	400.00	10. Real Estate	400.00
11. Other Assets	500.00	11. Other Assets	500.00
12. Total Assets	1,500.00	12. Total Liabilities and Capital	1,500.00
13. Cash	100.00	13. Cash	100.00
14. Bonds	200.00	14. Bonds	200.00
15. Stocks	300.00	15. Stocks	300.00
16. Real Estate	400.00	16. Real Estate	400.00
17. Other Assets	500.00	17. Other Assets	500.00
18. Total Assets	1,500.00	18. Total Liabilities and Capital	1,500.00
19. Cash	100.00	19. Cash	100.00
20. Bonds	200.00	20. Bonds	200.00
21. Stocks	300.00	21. Stocks	300.00
22. Real Estate	400.00	22. Real Estate	400.00
23. Other Assets	500.00	23. Other Assets	500.00
24. Total Assets	1,500.00	24. Total Liabilities and Capital	1,500.00
25. Cash	100.00	25. Cash	100.00
26. Bonds	200.00	26. Bonds	200.00
27. Stocks	300.00	27. Stocks	300.00
28. Real Estate	400.00	28. Real Estate	400.00
29. Other Assets	500.00	29. Other Assets	500.00
30. Total Assets	1,500.00	30. Total Liabilities and Capital	1,500.00

Plaintiff's Exhibit M

was objected to by the defendant and withdrawn by the plaintiff.

Plaintiff's Exhibit N.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT OF INCOME FOR FISCAL YEARS ENDED JUNE 30, 1910 TO JUNE 30, 1914, BOTH INCLUSIVE
AS PREPARED FOR "RETURN OF ANNUAL NET INCOME"

	Year Ended June 30, 1910	Year Ended June 30, 1911	Year Ended June 30, 1912	Year Ended June 30, 1913	Year Ended June 30, 1914	TOTAL
<i>Included in "Return of Annual Net Income"</i>						
Miscellaneous rentals.....	572.00	2,051.00	8,010.00	7,500.00	1,517.45	19,550.45
Income from lands and securities not pledged for the redemption of bonds.....	571,573.59	504,766.12	422,877.10	462,877.95	443,972.90	2,406,987.76
Interest on open accounts.....	153,916.72	214,402.32	1,074,316.98	787,406.74	116,906.18	2,302,122.94
Interest on loans and advances other than on open accounts with Proprietary and Affiliated Companies.....	74.28		30,867.11	7,486.56	30,028.72	68,456.71
Miscellaneous income.....	10,245.41	12,586.97	42,902.55	43,989.05	40,467.60	156,214.58
Rental from So. Pac. Co.....	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	50,000.00
Profits from leasehold operations.....	6,445,455.41	5,255,426.18	3,625,123.40	3,306,981.85	2,246,541.96	20,880,908.89
Interest in Wells Fargo & Co. contract.....	33,000.00	33,000.00				66,000.00
Income from sinking fund investments.....			14,443.70	8,796.10	21,808.11	45,107.91
Rental for lease of road.....				220,549.00	224,558.08	445,107.08
Interest on bonds owned.....				8,150.00	8,150.00	16,300.00
TOTAL.....	7,236,422.45	6,001,234.59	5,228,451.02	4,823,327.25	3,144,221.00	26,564,106.31
<i>Not included in "Return of Annual Net Income"</i>						
Proceeds of sale of unpledged lands.....	719.26					719.26
GROSS INCOME.....	7,237,141.71	6,001,234.59	5,228,451.02	4,823,327.25	3,144,221.00	26,564,825.57
DEDUCTIONS FROM GROSS INCOME						
<i>Included in "Return of Annual Net Income"</i>						
Land Department expenses.....	72,710.20	82,905.79	124,652.91	100,246.12	110,612.96	501,211.98
Land Department taxes.....	196,504.18	208,302.92				396,807.10
General and Miscellaneous expenses.....	14,198.07	15,697.32	7,846.04	12,319.51	8,790.51	56,650.05
Sinking fund contributions.....	20,000.00	50,000.00				100,000.00
Taxes in United States.....			289,147.17	265,263.68	291,519.65	845,930.50
TOTAL.....	393,412.45	356,906.03	421,446.12	368,829.31	410,923.12	1,932,689.03
<i>Not included in "Return of Annual Net Income"</i>						
Sinking fund requirements and earnings.....			65,443.70	58,796.10	72,808.11	196,107.91
TOTAL DEDUCTIONS FROM GROSS INCOME.....	393,412.45	356,906.03	486,890.42	427,625.41	483,731.23	2,128,796.94
NET INCOME TRANSFERRED TO PROFIT AND LOSS.....	6,903,729.26	5,730,328.56	4,741,560.60	4,417,301.84	2,660,489.77	24,404,128.57

PROFIT AND LOSS—DEBIT						
4 (a)	79 Commission on Bonds Sold.....	6,672.97	5,962.97	1,210.00		1,210.00
4 (a)	80 Premiums on Stocks and Bonds Redeemed.....					
5 (a)	81 Discount on Stock Extinguished Through Surplus.....					
5 (a)	82 Discount on Bonds Extinguished Through Surplus.....	114,296.14		114,296.14		114,296.14
5 (a)	83 Losses on Bond and Equipment Abandoned or Retired.....					
	Og. Un. Ry. & Depot Co.....	44,685.14				
4 (a)	84 Delayed Income Debits.....					
	Rental land Oakland Pier to Estuary.....	78,696.21				
5 (a)	85 Adjustment of Old Ledger Accounts.....					
	Operation Riverside Electric.....	1,806.17	198,296.52	198,296.52	22,686.75	145,292.51
5 (a)	86 Uncollectible Accounts Written Off.....					
5 (a)	87 Losses from Sale of Investment Securities.....					
5 (a)	88 Losses from Sale of Miscellaneous Real Estate.....					
	89					
	90					
	91					
	92 Dividends Paid on Preferred Stock.....	8,504,000.00	842,000.00	8,156,000.00	827,027.00	8,709,027.00
	93 Dividends Paid on Common Stock.....	4,086,580.00		4,086,580.00	406,973.00	4,444,905.00
	94 Balance—Surplus.....					
	Total.....		8,619,191.26	867,136.96	7,962,054.26	1,309,201.24
						9,244,405.92

INSTRUCTIONS

Item 66. Report under this item Interest on Loans, Advances, and on Open Accounts with Proprietary or Affiliated Companies.

Item 67. Report under this item Interest on Loans, Advances, and on Open Accounts other than with Proprietary or Affiliated Companies.

Item 71. Report under this item Interest on Funded and Other Indebtedness computed in the order of the indebtedness bearing the highest rate of interest. The remainder of the interest on the Funded and Other Indebtedness should be reported under Item 70.

Notes. In this column is designated the number of the item on Government Form 100, "Return of Annual Net Income," under which the items in Column 5 should be reported. Such items as are designated with a star (*) should not be taken up on Government Form 100.

35	Proceeds from Sale of Land Trust Fund.....				
36	Income from Land Trust Fund.....				
37	Proceeds from Sale of Unpledged Lands.....				
38	Delayed Income Credits.....				
39	Adjustment of Old Ledger Accounts.....	54.85		54.85	
40	Interest to 6/30/14 on prop. in S. F. purchased by SFCo. in Oct. '08—Prior.....	51,007.47		51,007.47	
	do Sub. 1/1/49.....	57,229.51		57,229.51	
41	Profit Derived from Sale of Miscellaneous Real Estate.....	331,674.23	331,674.23		
42	Discount on bonds purchased and cancelled.....	78,599.76	27,415.47	51,184.51	
43	Balance on land contracts outstanding.....	2,122,363.19		2,122,363.19	
44	Mission Bay State Grant.....	2,301,500.00		2,301,500.00	
45	Balance—Default.....			19,716,562.51	
	Total	3,971,965.22	1,380,739.00	27,229,779.44	

STATEMENT OF CAPITAL INDEBTEDNESS AND OTHER INDEBTEDNESS AS OF JUNE 30, 1914.

1	46 Paid Up Capital Stock Outstanding June 30, 1914.....	94,575,000.00
	47 Funded Debt Outstanding June 30, 1914.....	109,493,043.26
	48 Advances and Other Indebtedness Outstanding June 30, 1914.....	6,854,979.98
2	49 Total Bonded and Other Indebtedness Outstanding June 30, 1914.....	109,348,023.19

INSTRUCTIONS.

Item 18. Report under this item only interest on Loans, Advances and on Open Accounts with Proprietary or Affiliated Companies.

Item 19. Report under this item only interest on Loans, Advances and on Open Accounts other than with Proprietary and Affiliated Companies.

Item 48. Report under this item all Loans, Cash Advances, or Open Accounts, on which interest is accrued and charged to Income Account.

Items. In this column is designated the number of the item on Government Form 123, "Return of Annual Net Income," under which the item in Column 2 should be reported. Such items as are designated with a star (*) should not be taken up on Government Form 123.

7 (a)	77	Taxes—In United States.....
7 (b)	78	Taxes—In Foreign Countries.....

PROFIT AND LOSS—DEBIT

4 (a)	79	Commission on Bonds Sold.....
4 (a)	80	Premiums on Stocks and Bonds Redeemed.....
5 (a)	81	Discount on Stock Extinguished Through Surplus.....
5 (a)	82	Discount on Bonds Extinguished Through Surplus.....
5 (a)	83	Losses on Road and Equipment Abandoned or Retired.....
4 (a)	84	Delayed Income Debits.....
5 (a)	85	Adjustment of Old Ledger Accounts (Add Surveys N. Y. C. chq. 1157.08).....
5 (a)	86	Uncollectible Accounts Written Off.....
5 (a)	87	Losses from Sales of Investment Securities.....
5 (a)	88	Losses from Sale of Miscellaneous Real Estate Prior to 1/1/09.....
	89	Depreciation of Equipment to Jun. 30, 1913 Sub. of Floating Equipment to Jun. 30, 1913 Prior 1/1.....
	90	.....
	91	.....
	92	Dividends Paid on Preferred Stock.....
	93	Dividends Paid on Common Stock.....
	94	Balance—Surplus.....

Total.....

INSTRUCTIONS

- Item 66. Report under this item Interest on Loans, Advances, etc.
 Item 67. Report under this item Interest on Loans, Advances, etc.
 Item 71. Report under this item Interest on Funded and Other
 interest. The remainder of the interest on the F

Note. In this column is designated the number of the item on Government
 items so are designated with a star (*) should not be taken up as

	291,519.00	181,021.11	100,000.00		
			388,890.00		
	388,471.00		388,471.00		
Q. will	30,000.00	22,000.79	1,072.51		
	81,000.79		81,000.79		
1/00	1,942,549.28		1,942,549.28		
	1,981,008.78		1,981,008.78		
1/1/00	5,808.17		5,808.17		
	4,000,000.00	627,027.00	4,000,000.00		
	17,990,908.00	605,573.00	17,491,000.00		
	30,322,171.00	1,302,599.24	27,286,770.44		

and an Open Account with Proprietary or Affiliated Companies
 and an Open Account other than with Proprietary or Affiliated Companies.
 Other Indebtedness computed in the order of the indebtedness bearing the highest rate of
 the Fixed and Other Indebtedness should be reported under Item 70.

Report from 100, "Return of Assets and Liabilities," under which the Name is Column 1 should be reported. Item
 100 is the maximum from 100.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT OF PROFIT AND LOSS FOR FISCAL YEARS ENDED JUNE 30, 1910 TO JUNE 30, 1914, BOTH INCLUSIVE AS PREPARED FOR "RETURN OF ANNUAL NET INCOME"

	Year Ended June 30, 1910	Year Ended June 30, 1911	Year Ended June 30, 1912	Year Ended June 30, 1913	Year Ended June 30, 1914	Total
CREDIT						
Included in "Return of Annual Net Income"						
Material recovered.....		225.74				225.74
Income from securities accrued prior to July 1, 1911.....			106,264.99			106,264.99
Adjustment of old ledger accounts.....			1.00		54.65	55.65
Adjustment of interest on 9-1/2% bonds.....				16.67		16.67
Discount on bonds purchased and cancelled.....				66,478.27	78,000.00	145,078.26
Proportion of interest to June 30, 1914 on property in San Fran. purchased by So. Pac. Co. in 1905—Sub. to 1909.....					87,289.81	87,289.81
TOTAL.....		225.74	106,265.99	66,494.94	185,344.44	298,981.11
Not included in "Return of Annual Net Income"						
Restatement of leasehold operations—years 1906/8.....	90,064.27					90,064.27
Adjustment of discount on Preferred Stock issued to S. P. Co. to Mar. 31, 1908.....	141,000.00					141,000.00
Discount on bonds purchased and cancelled.....	25,097.78	206,819.66	61,318.40			292,835.79
Proceeds from sale of unpledged land.....	24.00					24.00
Proceeds of sale of lands pledged for the redemption of bonds.....	153,301.98	296,569.12	250,943.50	326,665.80	402,347.08	1,429,827.48
Annual payments to sinking funds and income from sinking fund investments.....	50,000.00	66,850.68	65,443.70	59,796.10	72,908.11	314,468.59
Readjustment of leasehold operations 1878 to 1899.....		701,252.22				701,252.22
Rentals collected Jan. to April 1907 from property on 7th St. Sacramento, Cal.....			1,113.90			1,113.90
Additions and Betterments and Equipment Expenditures appropriated from income, years 1900 and 1901.....			2,509,898.80			2,509,898.80
Readjustment of leasehold operations 1906-8 incl.....				408,018.81		408,018.81
Readjustment of leasehold operations 1909-11 "				546,000.00		546,000.00
Proportion of interest to June 30, 1914 on property in San Fran. purchased by So. Pac. Co. in 1905—Prior to 1909.....					51,007.47	51,007.47
Profit from sale of Rockaway Beach Property.....					361,674.88	361,674.88
Balance of land contracts outstanding.....					2,152,393.19	2,152,393.19
Mission Bay State Grant.....					2,301,500.00	2,301,500.00
TOTAL.....	466,496.25	1,280,691.08	2,588,613.80	1,340,480.71	5,361,760.18	11,029,042.10
GROSS CREDITS.....	466,496.25	1,280,917.42	2,694,879.29	1,406,975.65	5,887,784.68	11,367,973.31
DEBIT						

PAGE CUT OFF

Discount on bonds sold (1/85 of 8861000.86).....		110,314.40		288,100.22	88,892.91	487,307.53
Adjustments in unsettled claims and accounts.....		225.00	325.74	123,226.52	23,668.30	147,455.56
Discount on bonds sold (European Loan of 1911) (1/34th of 965,250.97).....			23,389.73			23,389.73
Loss on road and equipment abandoned or retired.....			93,916.91	114,226.14	382,471.85	595,614.90
Losses from sale of investment securities.....					81,690.76	81,690.76
Depreciation of equipment to June 30, 1913—Sub. to January 1, 1909.....					1,982,663.78	1,982,663.78
TOTAL	36,423.82	808,074.34	678,747.53	532,085.85	2,569,387.60	4,008,679.14
<i>Not Included in "Return of Annual Net Income"</i>						
Dividends on Preferred Stock.....	556,000.00	694,000.00	692,000.00	3,504,000.00	4,629,627.00	10,065,627.00
Dividends on Common Stock.....	4,086,530.00	6,737,550.00	4,086,530.00	4,086,530.00	17,900,008.00	36,737,143.00
Discount on bonds sold (European Loan of 1911) (34/35ths of 3,861,005.86).....		3,750,669.46		288,100.22	88,892.91	3,373,666.33
Discount on bonds sold (European Loan of 1911) (33/34ths of 965,250.97).....			936,861.24			936,861.24
Depreciation of equipment to June 30, 1913—Prior to Jan. 1, 1909.....					2,943,549.28	2,943,549.28
Depreciation of Floating Equipment to June 30, 1913—Prior to Jan. 1, 1909.....					5,806.17	5,806.17
Preliminary surveys—abandoned June 30, 1913—Prior to Jan. 1, 1909.....					981.05	981.05
TOTAL DEBITS	4,637,968.82	12,055,813.80	6,344,188.77	7,784,465.63	37,960,463.19	58,762,345.21
NET CREDITS						
NET DEBITS	4,159,467.80	10,785,396.38	3,649,269.48	6,377,499.38	22,422,758.57	47,304,873.00
BALANCE FROM INCOME	6,908,711.80	5,735,240.56	4,741,560.60	4,417,301.84	2,660,424.37	24,464,139.25
NET SURPLUS FOR YEAR	2,747,344.00		1,092,301.12			2,839,545.41
NET DEFICIT FOR YEAR		5,047,155.82		1,960,298.14	19,762,334.20	26,769,778.18

Plaintiff's Exhibit N.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT OF PROFIT AND LOSS FOR FISCAL YEARS ENDED JUNE 30, 1910, TO JUNE 30, 1914, BOTH INCLUSIVE
AS PREPARED FOR "RETURN OF ANNUAL NET INCOME"

SUMMARY	Year Ended June 30, 1910	Year Ended June 30, 1911	Year Ended June 30, 1912	Year Ended June 30, 1913	Year Ended June 30, 1914	TOTAL
Income included in "Return of Annual Net Income".....	7,236,432.45	6,091,324.59	5,238,451.03	4,863,827.25	3,144,221.00	26,564,166.81
Credits to Profit and Loss included in "Return of Annual Net Income".....		225.74	106,265.90	65,404.94	165,944.44	338,931.11
TOTAL	7,236,432.45	6,091,450.33	5,344,717.01	4,929,232.19	3,310,165.44	26,903,097.42
Deductions from Income included in "Return of Annual Net Income".....	330,440.45	351,904.08	421,446.72	386,820.31	410,938.59	1,902,639.08
Debits to Profit and Loss included in "Return of Annual Net Income".....	35,422.82	303,074.34	678,747.83	593,085.85	2,550,887.60	4,866,679.14
TOTAL	365,863.27	1,244,978.42	1,100,194.55	979,906.16	2,961,826.19	6,801,318.17
Net Income included in "Return of Annual Net Income".....	6,870,569.18	4,846,571.91	4,244,522.46	4,011,457.03	339,340.25	20,301,779.25
Income not included in "Return of Annual Net Income".....	719.86					719.86
Credits to Profit and Loss not included in "Return of Annual Net Income".....	469,406.30	1,300,601.68	2,588,613.30	1,340,480.71	5,361,760.18	11,029,049.10
TOTAL	469,416.11	1,300,601.68	2,588,613.30	1,340,480.71	5,361,760.18	11,029,761.98
Deductions from Income not included in "Return of Annual Net Income".....			65,443.70	59,796.10	72,008.11	196,107.91
Debits to Profit and Loss not included in "Return of Annual Net Income".....	4,322,320.00	11,122,292.42	5,685,391.24	7,262,429.78	25,301,075.59	54,063,666.07
TOTAL	4,322,320.00	11,122,292.42	5,750,834.94	7,312,225.88	25,463,043.70	54,361,773.98
Net Income not Included in "Return of Annual Net Income".....	4,122,312.80	9,821,690.74	5,142,221.64	5,971,745.17	20,102,168.53	43,232,012.00
Net Surplus for Year	2,747,246.38	5,024,881.17	1,092,300.12	1,980,289.14	10,762,384.20	2,890,545.41
Net Deficit for Year		5,024,881.17				26,799,773.76

STATISTICAL DATA

STATEMENT OF DEBTS AND CREDITS

NAME	ADDRESS	CITY	STATE	COUNTRY
J. H. HARRIS	123 Main St.	New York	N.Y.	U.S.A.
W. J. BROWN	456 Elm St.	Chicago	Ill.	U.S.A.
M. L. GREEN	789 Oak St.	Boston	Mass.	U.S.A.
R. S. WHITE	101 Pine St.	San Francisco	Calif.	U.S.A.
T. K. BLACK	234 Cedar St.	Philadelphia	Pa.	U.S.A.
L. P. GOLD	567 Birch St.	Los Angeles	Calif.	U.S.A.
C. D. SILVER	890 Spruce St.	Portland	Maine	U.S.A.
N. E. IRON	1122 Ash St.	Seattle	Wash.	U.S.A.
H. F. COPPER	1345 Maple St.	Denver	Colo.	U.S.A.
S. G. ZINC	1567 Walnut St.	St. Louis	Mo.	U.S.A.
K. J. LEAD	1789 Chestnut St.	Cincinnati	Ohio	U.S.A.
P. M. TIN	1901 Hickory St.	Indianapolis	Ind.	U.S.A.
Q. N. ALUMINUM	2123 Sycamore St.	Columbus	Ohio	U.S.A.
R. O. SILICON	2345 Magnolia St.	Nashville	Tenn.	U.S.A.
S. P. BORON	2567 Dogwood St.	Memphis	Tenn.	U.S.A.
T. Q. FLUORINE	2789 Redwood St.	San Jose	Calif.	U.S.A.
U. R. IODINE	2901 Juniper St.	Austin	Tex.	U.S.A.
V. S. BROMINE	3123 Cypress St.	Fort Worth	Tex.	U.S.A.
W. T. CHLORINE	3345 Fir St.	Dallas	Tex.	U.S.A.
X. Y. HYDROGEN	3567 Hawthorn St.	Houston	Tex.	U.S.A.
Y. Z. OXYGEN	3789 Laurel St.	Phoenix	Ariz.	U.S.A.
Z. A. NITROGEN	3901 Locust St.	San Antonio	Tex.	U.S.A.
A. B. CARBON	4123 Mulberry St.	San Diego	Calif.	U.S.A.
B. C. SULFUR	4345 Peach St.	San Jose	Calif.	U.S.A.
C. D. PHOSPHORUS	4567 Plum St.	San Francisco	Calif.	U.S.A.
D. E. POTASSIUM	4789 Rose St.	San Francisco	Calif.	U.S.A.
E. F. SODIUM	4901 Tulip St.	San Francisco	Calif.	U.S.A.
F. G. LITHIUM	5123 Violet St.	San Francisco	Calif.	U.S.A.
G. H. AMMONIUM	5345 Zinnia St.	San Francisco	Calif.	U.S.A.
H. I. NITRATE	5567 Azalea St.	San Francisco	Calif.	U.S.A.
I. J. SULFATE	5789 Camellia St.	San Francisco	Calif.	U.S.A.
J. K. PHOSPHATE	5901 Daffodil St.	San Francisco	Calif.	U.S.A.

Plaintiff's Exhibit O.**LETTER FROM COMMISSIONER OF INTERNAL REVENUE, DATED FEBRUARY 11. 1914.**

CT—in re: Addition special excise tax.

CENTRAL PACIFIC RAILWAY Co.,
870 Market St.,
San Francisco, Cal.

GENTLEMEN:—

This office is in receipt of the revenue agent's report relative to the examination of your books and records for the years 1909, 1910, 1911 and 1912, as a result of which examination, additional special excise taxes are recommended against your corporation in the sums of \$17,849.67, \$16,351.35, \$22,271.34 and \$38,419.48.

It is believed that you are familiar with the findings of the examining officer, but for your information the following memorandum showing the basis of the additional special excise taxes is submitted.

1909.

Disallowance of Sinking Fund Contribution	\$50,000.00
Disallowance of Excessive Interest.....	1,668,484.23
Disallowance of Interest paid in 1908	11,778.80
Disallowance of Bond discount not prorated	38,808.00
Prorated proceeds from sale of lands (Alameda Co.)	4,469.16
Prorated proceeds from sale of pledged lands.....	11,426.55
Additional taxable amount.....	<u>\$1,784,966.74</u>

Plaintiff's Exhibit O.

1910.

Sinking fund earnings omitted....	\$8.30
Prorated proceeds of sale of pledged lands	27,582.70
Discount on reacquired bonds canceled	37,030.80
Excessive interest.....	1,571,715.28

Total **\$1,636,337.08**
ALLOWED

Alameda Land expense... \$320.14	
Prorated Bond discount.. 882.00	1,202.14

Additional taxable amount..... **\$1,635,134.94**
1911.

Excessive interest.....	\$1,889,916.40
Proceeds from sale of lands pledged.	65,294.51
Sinking fund earnings.....	16,350.68
Discount on bonds reacquired and canceled	206,454.70
Sinking fund deduction disallowed..	50,000.00

Total **\$2,228,016.29**
ALLOWED

Prorated discount on bonds.....	882.00
---------------------------------	--------

Additional taxable amount..... **\$2,227,134.29**
1912.

Excessive interest.....	\$3,651,917.44
Sinking fund earnings.....	7,640.18
Prorated proceeds from sale of pledged lands.....	99,303.74
Discount on bonds purchased and cancelled	83,968.65

Total **\$3,842,830.01**
ALLOWED

Prorated discount on bonds sold..	882.00
-----------------------------------	--------

Additional amount taxable..... **\$3,841,948.01**

Plaintiff's Exhibit (1).

From a careful examination of the revenue agent's report, it appears that his recommendations are based upon the provisions of the law and the rulings of this office pertaining thereto, and consequently the additional taxes for the years 1910, 1911 and 1912 will be assessed within a short time. As it is necessary, in order to make the additional assessment for the year 1909, for the corporation to file a waiver of its rights under the law in that respect, you will please fill out and return the enclosed form of waiver.

Unless this waiver is filed by your corporation or the additional tax due for 1909 paid to the Collector without a formal demand therefor, it will be necessary to bring suit to recover the additional tax due for the year 1909.

Respectfully,

W. H. OSBORN

Commissioner.

Enclosure
CJY

Plaintiff's Exhibit P.

Form 1082

THE PENALTY for failure to have this Return in the hands of the Collector of Internal Revenue on or before March 1, or within 60 days after the close of the fiscal year, is a sum not exceeding \$10,000.

UNITED STATES INTERNAL REVENUE.**RETURN OF ANNUAL NET INCOME.**

(Section 2, Act of Congress approved October 3, 1913.)

PUBLIC SERVICE CORPORATIONS.

RETURN OF NET INCOME received during the calendar year ended December 31st, 1913, by CENTRAL PACIFIC RAILWAY COMPANY the principal place of business of which is located for the purpose of this return, at 870 Market Street, City or Town of San Francisco, in the State of California, this return being subject to the attached memorandum which is made a part hereof.*

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

- | | |
|--|------------------|
| 1. Total amount of paid-up capital stock outstanding at close of the year, or if no capital stock, the capital employed in the business at the close of the year | \$84,675,500.00 |
| 2. Total amount of bonded and other indebtedness outstanding at close of year | \$189,444,548.26 |

3. GROSS INCOME (see Note A)	\$4,955,545.84
------------------------------------	----------------

DEDUCTIONS.

- | | |
|--|---------------|
| 4. (a) Total amount of all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation, EXCLUSIVE OF INTEREST PAYMENTS. (See Note B) | \$ 134,506.40 |
| (b) All rentals or other payments required to be made as a condition to the continued use or possession of the property | \$ |
| 5. (a) Total amount of losses sustained during the year not compensated by insurance or otherwise | \$ 547,658.67 |
| (b) Total amount of depreciation for the year | \$ |
| 6. (a) Total amount of interest accrued and paid within the year on an amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year | \$ |

(*The memorandum referred to is a protest and is omitted.)

Plaintiff's Exhibit P.

(b) Total amount of interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions..	\$ 272,765.35	
7. (a) Total taxes paid during the year, imposed under authority of the United States or any State or Territory thereof	\$	
(b) Foreign taxes paid.....	\$	
TOTAL DEDUCTIONS.....		\$954,900.43
8. Net income on which tax at 1 per centum is calculated 4,000,615.42 less 1/6.....		\$ 3,338,846.18

STATE OF CALIFORNIA, County of San Francisco, TO WIT:

W. R. SCOTT, Vice-President, and H. A. JONES, Treasurer, of the Central Pacific Railway Company, a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, depose and says that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the year stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed.

SWORN AND SUBSCRIBED to before me this 25th day of February, 1914.

W. R. SCOTT,
Vice-President.
H. A. JONES,
Asst. Treasurer.

SEAL OF
OFFICER
TAKING
AFFIDAVIT.

E. B. RYAN,
Notary Public in and for the City
and County of San Francisco,
State of California.

NOTE A.—Gross income shall consist of the total revenues derived from the operation and management of its business and properties, together with all amounts of income from other sources, including dividends received on stock of other organizations, whether subject to this tax or not, and interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions, as shown by entries upon its books during the year for which return is made.

NOTE B.—The deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered upon its books during the year. Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to capital account, should not be deducted in ascertaining annual net income. Interest paid on mortgage indebtedness on real estate occupied or used by a corporation may be deducted under Item 4, if the interest is paid as rental or franchise charge, payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in Item 4 should be stated separately under Item 4 (b).

At the foot of this return the following note was appended, viz:

The Central Pacific Railway is leased by the Southern Pacific Company and for months of January and February, 1913, no excise tax was therefore payable. Of \$547,658.67 reported against Item 5 (a) \$38,199.69 covered discount on bonds issued prior to January 1, 1909.

Plaintiff's Exhibit P.

Form 1095.

THE PENALTY for failure to have this Return in the hands of the Collector of Internal Revenue on or before March 1, or within 90 days after the close of the fiscal year, is a sum not exceeding \$10,000.

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME.
(Section 2, Act of Congress approved October 3, 1913.)

PUBLIC SERVICE CORPORATIONS.

RETURN OF NET INCOME received during the six months ended June 30th, 1914, by CENTRAL PACIFIC RAILWAY COMPANY, the principal place of business of which is located for the purpose of this return at 870 Market Street City or Town of San Francisco, in the State of California, this return being subject to the attached memorandum, which is made a part hereof.*

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

- | | |
|---|------------------|
| 1. Total amount of paid-up capital stock outstanding at close of the six months, or if no capital stock, the capital employed in the business at the close of the six months..... | \$94,675,500.00 |
| 2. Total amount of bonded and other indebtedness outstanding at close of year..... | \$196,348,008.19 |
| 3. Gross Income (see Note A)..... | \$2,674,999.70 |

DEDUCTIONS.

- | | |
|---|----------------|
| 4. (a) Total amount of all the ordinary and necessary expenses paid within the six months in the maintenance and operation of the business and properties of the corporation, EXCLUSIVE OF INTEREST PAYMENTS. (See Note B.)..... | \$52,637.73 |
| (b) All rentals or other payments required to be made as a condition to the continued use or possession of the property..... | \$ |
| 5. (a) Total amount of losses sustained during the six months not compensated by insurance or otherwise..... | \$2,587,291.81 |
| (b) Total amount of depreciation for the six months..... | \$ |
| 6. (a) Total amount of interest accrued and paid within the six months on an amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the six months or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year..... | \$ |

* The memorandum referred to is a protest and is omitted.

Plaintiff's Exhibit P.

(b) Total amount of interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions.....	\$	
7. (a) Total taxes paid during the six months imposed under authority of the United States or any State or Territory thereof.....	\$156,694.34	
(b) Foreign taxes paid.....	\$	
TOTAL DEDUCTIONS.....		\$2,746,623.68
8. Net income on which tax at 1 per centum is calculated.....	\$	None

NOTE.—The above blank spaces for figures should show the amount of each respective item. If there is nothing to return as to any item, the word "none" must be written in such blank spaces.

STATE OF CALIFORNIA, County of San Francisco, to wit:

T. O. EDWARDS, Auditor, and W. F. INGRAM, Asst. Treasurer of the Central Pacific Railway Company, a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, depose and say that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the six months stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed.

SWORN AND SUBSCRIBED to before me this 28th day of September, 1914

T. O. EDWARDS
Auditor.

SEAL OF OFFICER :
TAKING :
AFFIDAVIT :
..... :
E. B. RYAN
Notary Public in and for the
City and County of San Francisco
State of California.

W. F. INGRAM
Asst. Treasurer.

NOTE A.—Gross income shall consist of the total of the gross revenues derived from the operation and management of its business and properties, together with all amounts of income from other sources, including dividends received on stock of other organizations, whether subject to this tax or not, and interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions, as shown by entries upon its books during the year for which the return is made.

NOTE B.—The deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered on its books during the year. Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to capital account, are not proper deductions in ascertaining annual net income. Interest paid on mortgage indebtedness on real estate occupied or used by a corporation may be deducted in Item 4, if the interest is paid, as a rental or franchise charge, payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in Item 4 should be stated separately under Item 4 (b).

At the foot of this return the following note was appended, viz.:

No part of proceeds of land grant sales has been included in item 3 pending adjustment with Government. Of \$2,537,291.81 reported against item 5 (a) \$19,090.85 covers discount on bonds issued prior to January 1, 1909.

Plaintiff's Exhibit Q.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT OF INCOME FOR FISCAL YEARS ENDED JUNE 30, 1910, TO JUNE 30, 1914, BOTH INCLUSIVE AS PREPARED FOR
"RETURN OF ANNUAL NET INCOME"

(Showing changes made by Internal Revenue Department)

	Year Ended June 30, 1910	Year Ended June 30, 1911	Year Ended June 30, 1912	Year Ended June 30, 1913	Year Ended June 30, 1914	TOTAL
INCLUDED IN "RETURN OF ANNUAL NET INCOME" AS FILED						
Miscellaneous rentals	872.00	3,051.00	3,010.00	7,500.00	1,617.45	19,550.45
Income from lands and securities not pledged for the redemption of bonds	571,873.59	564,766.12	422,877.19	462,877.95	443,972.90	2,466,367.75
Interest on open accounts	158,910.73	214,402.32	1,074,516.98	787,496.74	116,996.18	2,862,122.94
Interest on loans and advances other than on open accounts with Proprietary and Affiliated Companies	74.32		30,867.11	7,496.56	20,028.72	68,456.71
Miscellaneous income	16,346.41	12,588.97	43,802.55	43,989.05	40,487.60	156,214.58
Rental from So. Pac. Co.	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	50,000.00
Profits from leasehold operations	6,443,855.41	5,255,426.18	3,625,183.49	3,306,961.86	2,246,541.96	30,880,988.89
Interest in Wells Fargo & Co. contract	32,000.00	32,000.00				64,000.00
Income from sinking fund investments			14,443.70	8,796.10	21,898.11	45,107.91
Rental for lease of road				220,549.00	224,556.06	445,107.06
Interest on bonds owned				8,150.00	8,150.00	16,300.00
TAXABLE INCOME ADDED BY INTERNAL REVENUE DEPARTMENT UPON EXAMINATION OF ACCOUNTS						
Additional profits from leasehold operations account reduction of interest deduction made therefrom	1,620,099.76	1,730,815.84	2,770,916.92	1,835,958.72		7,947,791.24
Proceeds of sale of unpledged lands	719.88					719.88
GROSS INCOME	8,857,262.00	7,822,050.48	7,990,367.94	6,680,785.97	3,144,221.00	34,512,677.43
DEDUCTIONS FROM GROSS INCOME						
INCLUDED IN "RETURN OF ANNUAL NET INCOME" AS AMENDED BY INTERNAL REVENUE DEPARTMENT						
Land Department expenses	72,710.20	83,993.70	124,652.91	109,246.12	110,618.98	501,221.96
Land Department taxes	193,584.18	208,802.92				402,387.10
General and miscellaneous expenses	14,196.07	15,697.32	7,646.64	12,319.51	8,790.51	58,650.05
Taxes in United States			280,147.17	265,268.68	291,519.05	845,922.90
TOTAL	280,440.45	302,994.08	421,446.72	386,829.31	410,928.52	1,802,639.08
NOT INCLUDED IN "RETURN OF ANNUAL NET INCOME" AS FINALLY AMENDED						
Sinking fund contributions disallowed in making additional assessment	50,000.00	50,000.00				100,000.00
*Sinking fund requirements and earnings			65,443.70	59,796.10	72,898.11	198,107.91
Interest netted against profits from leasehold operations and exceeding interest based on an amount in excess of capital stock	1,620,099.76	1,730,815.84	2,770,916.92	1,835,958.72		7,947,791.24

PAGE CUT OFF

TOTAL.....	1,670,069.70	1,780,815.84	2,836,800.63	1,838,784.81	72,888.11	8,240,839.10
TOTAL DEDUCTIONS.....	1,950,540.31	2,083,609.87	3,257,807.34	2,272,584.13	483,796.63	10,048,538.18
NET INCOME TRANSFERRED TO PROFIT AND LOSS.....	6,906,711.39	5,738,240.56	4,741,560.60	4,417,201.84	2,600,424.37	24,464,139.25

* Not deducted in return of annual net income as originally filed.

Issued by Accounting Department
San Francisco, Cal., Sept. 1, 1916.

Correspondence in relation to this statement should
be addressed to the Auditor.

CENTRAL PACIFIC RAILWAY COMPANY

STATEMENT OF PROFIT AND LOSS FOR FISCAL YEARS ENDED JUNE 30, 1910 TO JUNE 30, 1914, BOTH INCLUSIVE AS PREPARED FOR "RETURN OF ANNUAL NET INCOME"

(Showing changes made by Internal Revenue Department)

	Year Ended June 30, 1910	Year Ended June 30, 1911	Year Ended June 30, 1912	Year ended June 30, 1913	Year ended June 30, 1914	TOTAL
CREDIT						
INCLUDED IN "RETURN OF ANNUAL NET INCOME"						
Material recovered.....		225.74				225.74
Income from securities accrued prior to July 1, 1911.....			106,264.99			106,264.99
Adjustment of old ledger accounts.....			1.00		54.65	55.65
Adjustment of interest on 3-1/2% bonds.....				16.67		16.67
Discount on bonds purchased and cancelled.....				66,478.27	78,599.98	145,078.25
Proportion of interest to June 30, 1914, on property in San Francisco purchased by So. Pac. Co. in 1905—sub. to 1909.....					87,289.81	87,289.81
TOTAL.....		225.74	106,265.99	66,494.94	165,944.44	338,931.11
ADDITIONAL CREDITS UPON WHICH TAXES WERE ASSESSED BY INTERNAL REVENUE DEPARTMENT						
Sinking fund earnings.....	8.30	16,350.68	7,640.18			23,999.16
Pro-rated proceeds from sale of pledged lands.....	17,838.84	59,394.65	66,636.22	36,959.73		180,819.44
Proceeds from sale of pledged lands.....	24.00					24.00
Discount on bonds purchased and cancelled.....	25,097.73	206,519.66	61,213.40			292,830.79
TOTAL.....	42,968.87	282,254.99	135,489.80	36,959.73		497,673.39
TOTAL PROFITS UPON WHICH TAX WAS ASSESSED.....	42,968.87	282,480.73	241,755.79	108,454.67	165,944.44	806,004.50
NOT INCLUDED IN "RETURN OF ANNUAL NET INCOME"						
Restatement of leasehold operations—years 1906-08.....	99,064.27					99,064.27
Adjustment of discount on Preferred Stock issued to S. P. Co. to Mar. 31, 1908.....	141,000.00					141,000.00
Proceeds of sale of lands pledged for the redemption of bonds.....	135,468.09	136,184.47	184,307.28	289,706.07	402,347.06	1,248,007.99
Annual payments to sinking funds and income from sinking fund investments.....	50,000.00	50,000.00	57,803.52	59,796.10	72,869.11	280,467.73
Readjustment of leasehold operations 1878 to 1898.....		701,252.22				701,252.22
Rentals collected Jan. to April 1907 from property on 7th St. Sacramento, Cal.....			1,113.90			1,113.90
Additions and betterments and equipment expenditures appropriated from income, years 1900 and 1901.....			2,209,898.80			2,209,898.80
Readjustment of leasehold operations 1906-08 incl.....				408,018.81		408,018.81
Readjustment of leasehold operations 1909-11 incl.....				546,000.00		546,000.00
Proportion of interest to June 30, 1914, on property in San Fran. purchased by So. Pac. Co. in 1905—prior to 1909.....					51,007.47	51,007.47
Profit from sale of Rockaway Beach Property.....					381,674.33	381,674.33
Balances of land contracts outstanding.....					2,152,363.19	2,152,363.19

PAGE CUT OFF

TOTAL.....	425,527.36	987,436.69	2,453,123.50	1,303,520.95	5,361,760.18	10,531,368.71
GROSS CREDITS.....	468,496.23	1,269,917.42	2,694,879.29	1,406,975.65	5,527,704.62	11,367,973.21
DEBIT.						
INCLUDED IN "RETURN OF ANNUAL NET INCOME"						
Property abandoned.....	33,921.32	30,355.45				64,276.77
Uncollectible Accounts written off.....	1,512.50					1,512.50
Commissions on bonds sold (European Loan of 1911).....		752,179.49	551,115.15	6,472.97		1,309,767.61
Discount on bonds sold " (1/35 of 8861003.86).....		110,314.40		288,100.22	88,892.91	487,307.53
Adjustments in unsettled claims and accounts.....		225.00	325.74	133,236.52	23,668.30	147,455.56
Discount on bonds sold (European Loan of 1911) (1/34th of 965,250.97).....			28,389.73			28,389.73
Loss on road and equipment abandoned or retired.....			98,916.91	114,236.14	382,471.85	595,614.90
Losses from sale of investment securities.....					81,690.76	81,690.76
Depreciation of equipment to June 30, 1913—sub. to January 1, 1909.....					1,982,663.78	1,982,663.78
TOTAL.....	35,433.82	893,074.34	678,747.53	532,035.85	2,559,387.60	4,608,679.14
Additional pro-rate bonds sold in 1909 allowed by internal revenue department in examining Return of Annual Net Income.....	882.00	882.00	882.00	441.00		3,087.00
TOTAL DEDUCTIONS ALLOWED.....	36,315.82	893,956.34	679,629.53	532,476.85	2,559,387.60	4,701,766.14
NOT INCLUDED IN "RETURN OF ANNUAL NET INCOME"						
Dividends on Preferred Stock.....	556,000.00	684,000.00	692,000.00	3,504,000.00	4,629,627.00	10,065,627.00
Dividends on Common Stock.....	4,036,530.00	6,727,550.00	4,036,530.00	4,036,530.00	17,900,003.00	36,737,143.00
Discount on bonds sold.....	882.00	3,749,807.46	935,979.24	288,541.22	88,892.91	4,307,470.57
Depreciation of equipment to June 30, 1913—prior to January 1, 1909.....					2,943,549.28	2,943,549.28
Depreciation of Floating Equipment to June 30, 1913—prior to Jan. 1, 1909.....					5,808.17	5,808.17
Preliminary surveys—abandoned June 30, 1913—prior to Jan. 1, 1909.....					981.05	981.05
TOTAL DEBITS.....	4,627,965.82	13,055,313.80	6,344,138.77	7,784,465.63	27,950,463.19	58,763,345.21
NET CREDITS.....	4,159,167.69	10,785,396.38	3,649,259.48	6,377,489.96	23,432,758.57	47,394,372.00
NET DEBITS.....	6,906,711.88	5,738,240.56	4,741,560.60	4,417,201.34	2,600,424.87	24,464,139.25
BALANCE FROM INCOME.....	2,747,344.29		1,092,301.12			3,839,545.41
NET SURPLUS FOR YEAR.....		5,047,155.82		1,900,288.14	19,702,334.20	26,709,778.16

Plaintiff's Exhibit R.

CENTRAL PACIFIC RAILWAY COMPANY

**STATEMENT SHOWING INCOME AND PROFIT AND LOSS UPON WHICH INCOME TAX WAS PAID FOR FISCAL YEARS
JUNE 30, 1910 TO JUNE 30, 1914 INCLUSIVE
(PAYMENTS MADE ON BASIS OF CALENDAR YEAR)**

	Year ended June 30, 1910	Year ended June 30, 1911	Year ended June 30, 1912	Year ended June 30, 1913	Year ended June 30, 1914	Total
Income.....	8,857,252.00	7,822,080.43	7,999,387.94	6,698,785.97	3,144,221.00	34,512,677.43
Income deductions allowed there- from.....	280,440.45	302,994.03	421,446.72	386,829.31	410,923.52	1,802,639.03
Net income upon which tax has been paid.....	8,576,811.54	7,519,086.40	7,577,921.22	6,302,956.66	2,733,297.48	32,710,038.40
Profit and Loss Credits.....	42,968.97	282,480.73	241,755.79	108,454.67	165,944.44	834,604.50
Profit and Loss Debits.....	36,315.52	868,956.34	679,639.53	532,476.85	2,559,387.60	4,701,766.14
Net profit upon which tax has been paid.....	6,653.05	611,475.61	437,873.74	429,022.18	2,398,443.16	3,865,161.64
Net income and profit upon which tax has been paid.....	8,583,464.59	6,907,562.01	7,140,047.48	5,878,934.48	339,849.32	28,844,876.76

Plaintiff's Exhibit 8.**CENTRAL PACIFIC RAILWAY COMPANY****STATEMENT SHOWING EXCESS OF DIVIDENDS PAID OVER TAXABLE
NET INCOME, INCLUDING PROFIT AND LOSS TRANSACTIONS,
FOR FISCAL YEARS ENDING JUNE 30, 1910 TO
JUNE 30, 1914 INCLUSIVE.**

1909			
June 30, 1909	1909—Surplus (as per ledger)		\$25,250,361.01
June 30, 1910	By total credits to Income during year ended June 30, 1910	\$35,948,938.87	
June 30.	Less: Total debits same period	27,372,127.23	
		<hr/>	8,576,811.64
	By total credits to Profit and Loss during same period	\$42,968.87	
	Less total debits—same period	36,315.82	6,653.05
		<hr/>	8,583,464.69
	Net credit to Surplus during year..		
	<i>Disposition</i>		
	Dividends 6% on Common stock	4,086,530.00	
	Dividends 2% on Preferred stock ...	556,000.00	
		<hr/>	4,592,530.00
	Balance added to surplus	3,990,934.69	3,990,934.69
		<hr/>	
1910			
June 30. 1911	By Surplus		\$29,241,296.00
June 30.	By total credits to Income during year ended June 30, 1911	33,584,651.32	
	Less: total debits same period	26,065,594.92	
		<hr/>	7,519,056.40
	By total credits to Profit and Loss same period	282,480.73	
	Less: total debits same period	893,956.34	611,475.61
		<hr/>	6,907,580.79
	Net credit to surplus during year..		
	<i>Disposition</i>		
	Dividend 6% on common stock	4,086,530.00	
	" 4% extra common stock ..	2,691,020.00	
	" 2% on Preferred stock ...	684,000.00	
		<hr/>	7,411,550.00
	Dividends paid in excess of surplus for the year		508,969.21
			<hr/>
1911			
June 30.	By Surplus		\$28,737,327.30

Plaintiff's Exhibit S.

1911			
June 30	By Surplus		\$28,737,327.39
1912			
June 30	By total credits to Income during year ended June 30, 1912	\$34,197,154.42	
	Less total debits same period	26,619,233.20	
		<u>7,577,921.22</u>	
	By total credits to Profit and Loss same period	\$241,755.79	
	Less: Total debits same period	679,629.53	437,873.74
	Net credit to surplus during year...		7,140,047.48
	<i>Disposition:</i>		
	Dividend 6% on common stock	4,086,530.00	
	" 2% " preferred "	692,000.00	
		<u>4,728,530.00</u>	
	Balance added to Surplus		2,411,517.48
1913			
June 30	By Surplus		31,148,844.87
1913			
June 30	By total credits to Income during year ended June 30, 1913	36,831,989.92	
	Less: Total debits—same period	30,529,033.26	
		<u>6,302,956.66</u>	
	By total credits to Profit and Loss same period	103,454.67	
	Less: Total debits same period	532,476.85	429,022.18
	Net credit to surplus during year...		5,873,934.48
	<i>Disposition:</i>		
	Dividend 6% on Common stock	4,086,530.00	
	" 2% each (\$3) on Preferred stock	1,044,000.00	
	" (Special) to bring divi- dends on Preferred stock up to 6% same as on common stock	2,460,000.00	
		<u>7,540,530.00</u>	
	Dividends paid in excess of surplus for year		1,666,595.52

Plaintiff's Exhibit S.

1913			
June 30	By Surplus.....		29,482,249.35
1914			
June 30	By total credits to income during year ended June 30, 1914.....	34,811,177.53	
	Less: Total debits same period.....	32,077,685.05	
		<u>2,733,292.48</u>	
	By total credits to Profit and Loss same period.....	165,944.44	
	Less—Total debits— same period.....	12,559,387.60	
		<u>\$2,893,443.16</u>	
	Net credit to surplus during year...	339,849.32	
	<i>Disposition</i>		
	Dividend a/c sale of Rockaway Beach property on common stock.....	408,873.00	
	Dividends 20% (Special) on Common stock.....	13,455,100.00	
	Dividend 6% on Common Stock....	4,036,530.00	
	" 3% (2) on Preferred Stock.	1,044,000.00	
	" (a/c sale of Rockaway Beach Property) on Preferred Stock.....	105,627.00	
	Dividends 20% (Special) on Preferred Stock.....	3,480,000.00	
		<u>22,529,630.00</u>	
	Dividends paid in excess of surplus for the year.....		<u>\$22,189,780.68</u>
1914			
June 30	By Surplus.....		\$7,292,468.67

Plaintiff's Exhibit T.**CENTRAL PACIFIC RY. CO.****SUMMARY SHOWING EXCESS OF DIVIDENDS OVER
TAXABLE INCOME AND PROFITS REPORTED ON
"RETURNS OF ANNUAL NET INCOME."****PERIOD COVERING FISCAL YEARS ENDED JUNE 30, 1910
TO JUNE 30, 1914 INCL.**

Surplus year ending June 30, 1910 after payment of dividends.....	\$3,990,984.69
Deficit year ending June 30, 1911 after payment of dividends.....	508,969.21
Balance paid from Surplus prior to July 1, 1909.....	8,486,965.48
Surplus year ending June 30, 1912 after payment of dividends.....	2,411,517.48
Balance paid from Surplus prior to July 1, 1909 of dividends paid since that date.....	5,898,482.96
Deficit year ended June 30, 1913 after payment of dividends.....	1,666,595.52
Balance paid from Surplus prior to July 1, 1909 of dividends paid since that date.....	4,231,887.44
Deficit year ended June 30, 1914 after payment of dividends.....	22,189,780.68
Balance paid from Surplus prior to July 1, 1909 of dividends paid since that date.....	17,957,893.24

Plaintiff's Exhibit U

is a copy of the Articles of association of the Central Pacific Railway Company showing that the said Company is a Railroad Corporation organized under the laws of the State of Utah in the year 1899.

Order Filing Bill of Exceptions.

I, the undersigned, Judge of the District Court of the United States for the Southern District of New York, upon consent of the attorneys for the respective parties hereto, hereby certify that the foregoing is hereby settled and signed and approved as a true and correct bill of exceptions comprising a complete transcript of the proceedings had upon the trial of the above entitled cause, and of the testimony, and of all the evidence introduced and offered upon the trial of said cause. I direct that this bill of exceptions be attested and filed with the Clerk of said Court.

WITNESS my hand at the Borough of Manhattan in the City and State of New York, this 6th day of March, 1917.

MARTIN T. MANTON,
United States District Judge.

[SEAL]

ATTEST:

Alex. Gilchrist, Jr.
Clerk.

The undersigned hereby consent to the settling, signing and sealing of the foregoing as a true and correct bill of exceptions in this cause.

Dated, New York, March 5, 1917.

GORDON M. BUCK,
Attorney for plaintiff.

H. SNOWDEN MARSHALL,
U. S. Attorney, Attorney for defendant.

United States District Court, Southern District of New York.

L-14-300.

SOUTHERN PACIFIC COMPANY, Plaintiff,

against

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for
the Second District of New York, Defendant.

And now comes the Southern Pacific Company, plaintiff in the above entitled action, and says: That on or about the 14th day of March, 1917, the United States District Court for the Southern District of New York entered a judgment herein in favor of the defendant and against this plaintiff, in which judgment and the proceedings had prior thereto in this cause certain errors were committed to the prejudice of this plaintiff, all of which will more in detail appear from the Assignment of Errors which is filed with this petition.

Wherefore, this plaintiff prays that a Writ of Error may issue in this behalf out of the Supreme Court of the United States for the correction of errors so complained of, and that a transcript of the record, proceedings and papers in this cause, duly authenticated, may be sent to the Supreme Court of the United States.

GORDON M. BUCK,

Attorney for Plaintiff, Southern Pacific Company.

Office and Post Office Address, 165 Broadway, Manhattan, City of
New York, N. Y.

United States District Court, Southern District of New York.

L-14-300.

SOUTHERN PACIFIC COMPANY, Plaintiff,

against

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for
the Second District of New York, Defendant.

Now comes the Southern Pacific Company, the plaintiff above named, and, in connection with its petition for a writ of error, makes and files this its assignment of errors.

I. The United States District Court for the Southern District of New York erred in denying the plaintiff's motion for the direction of a verdict in its favor for the sum of \$34,800, being the amount of a tax paid by the plaintiff under protest on August 13, 1915,

which the defendant claimed the right to collect under the terms of the Act of Congress entitled "An Act to reduce tariff duties and provide revenue for the Government, and for other purposes," approved October 3, 1913 (hereinafter referred to as the Act). Such refusal was erroneous, because the undisputed evidence showed that the said sum was a tax imposed upon a special dividend of twenty per cent. paid by the Central Pacific Railway Company on its preferred capital stock and received by the plaintiff in January, 1914, and that such dividend was paid out of a surplus accumulated by the said Railway Company prior to the adoption of the Sixteenth Amendment to the Constitution of the United States and prior to the 1st day of July, 1909; and the Act did not impose a tax on dividends paid from such a surplus, for the following reasons, among others, viz.:

1. To construe the Act as imposing a tax on the said dividends so received by the plaintiff would contravene its terms.

2. The Act, being a tax statute, ought to be strictly construed against the Government and in favor of the taxpayer.

3. The Act ought not to be given a retroactive construction.

4. Inequality and hardship result from the construction given to the Act by the said Court in this cause.

5. The undisputed evidence showed that the plaintiff has owned the entire capital stock of the said Railway Company since the latter's organization in the year 1899, and during that entire period the plaintiff has acted as the banker of the said Railway Company and has also operated its railroads and appurtenant properties under lease. The plaintiff was, therefore, in possession of the moneys and other assets of the said Railway Company long prior to the declaration of the dividend in question, and the fiction of corporate entity ought to be disregarded.

6. As construed by the said Court in this cause, the Act is repugnant to the Constitution of the United States, for the following reasons, among others, viz.:

- (a) A direct tax is imposed without the apportionment required by the Constitution of the United States (Article I, Section 2, third clause; as amended by Fourteenth Amendment; and Article I, Section 9, fourth clause).

- (b) The tax is imposed on capital, and not on income, and, therefore, is not exempted by the Sixteenth Amendment to the Constitution of the United States from the apportionment so required. The Sixteenth Amendment should not be given a retroactive construction.

- (c) The tax is so unequal in operation as to result in the deprivation of property without due process of law, and as to constitute the taking of private property for public use without just compensation, in contravention of the Fifth Amendment to the Constitution of the United States, and in contravention of the implied limitations upon the taxing powers of Congress.

7. The Act ought to be so construed as to avoid raising any Constitutional question.

8. The Act should be so construed as to form with statutes in *pari materia* a consistent whole. It should also be construed in the light of decisions thereunder, as well as under the Act.

II. The said Court erred in denying the plaintiff's motion for the direction of a verdict in its favor for the sum of \$134,551, being the amount of a tax paid by the plaintiff under protest on August 13, 1915, which the defendant claimed the right to collect under the terms of the Act. Such refusal was erroneous because the undisputed evidence showed that the said sum was a tax imposed upon a special dividend of twenty per cent. paid by the said Railway Company on its common capital stock and received by the plaintiff in January, 1914; and that such dividend was paid out of a surplus accumulated by the said Railway Company prior to the adoption of the Sixteenth Amendment to the Constitution of the United States and prior to the 1st day of July, 1909; and the Act did not impose a tax on dividends paid from such a surplus, for the reasons, among others, hereinbefore set forth in paragraph numbered I hereof.

III. The said Court erred in denying the plaintiff's motion for the direction of a verdict in its favor for the sum of \$5,140, being the amount of a tax paid by the plaintiff under protest on August 13, 1915, which the defendant claimed the right to collect under the terms of the Act. Such refusal was erroneous, because the undisputed evidence showed that the said sum was a tax imposed upon a special dividend paid by the said Railway Company pro rata on its preferred and common capital stock and received by the plaintiff in January, 1914, and that such dividend was paid out of a surplus accumulated by the said Railway Company prior to the adoption of the Sixteenth Amendment to the Constitution of the United States and prior to the 1st day of July, 1909; and the Act did not impose a tax on dividends paid from such a surplus, for the reasons, among others, hereinbefore set forth in paragraph numbered I hereof.

IV. The said Court erred in denying the plaintiff's motion for the direction of a verdict in favor of the plaintiff for the sum of \$183,615.97, being the amount of a tax paid by the plaintiff under protest on August 13, 1915, which the defendant claimed the right to collect under the terms of the Act. Such refusal was erroneous, because the undisputed evidence showed that the said sum was a tax imposed upon four dividends aggregating \$18,361.597.48, paid by the said Railway Company and received by the plaintiff in January and June, 1914; and that such dividends were paid out of a surplus accumulated by the said Railway Company prior to the adoption of the Sixteenth Amendment to the Constitution of the United States and prior to the 1st day of July, 1909; and the Act did not impose a tax on dividends paid from such a surplus, for the

reasons, among others, hereinbefore set forth in paragraph numbered I hereof.

V. The said Court erred in denying the plaintiff's motion for the direction of a verdict in its favor for at least the sum of \$39,154.48, for the additional reason that \$3,915,448.48 of the dividends hereinbefore referred to were paid from the proceeds of sale of capital assets.

VI. The said Court erred in denying the plaintiff's motion for the direction of a verdict in its favor, with interest thereon at the rate of six per cent. per annum from August 13, 1915, the date upon which the said tax was paid as aforesaid to the date of the entry of judgment herein.

VII. The said Court erred in directing a verdict for the defendant, for each and all of the reasons hereinbefore set forth.

VIII. The said Court erred in denying the plaintiff's motion to strike out the testimony of the witness Angus D. McDonald as to the various corporations, other than the said Railway Company, in which the plaintiff owned stock during the six months' period ending June 30, 1914, and as to the amount of such stock held. Such refusal was erroneous for the reason that the question at issue in this cause was whether the plaintiff was subject to the tax levied upon certain dividends received by it from the said Railway Company, and not whether the plaintiff had other income which might have been taxed under the Act.

IX. The said Court erred in admitting, over the plaintiff's objection, testimony by the said witness that the plaintiff had not included in its income tax return for the said six months' period ending June 30, 1914, income that had accrued to corporations in which the plaintiff owned stock, but that had not been distributed to the plaintiff as dividends. Such refusal was erroneous for the reasons hereinbefore set forth in paragraph numbered VIII hereof.

X. The Court erred in denying the plaintiff's motion to strike out the testimony hereinbefore described in paragraphs numbered VIII and IX hereof, upon the following admission made by the defendant's counsel during the course of the trial of this cause, viz:

"The defendant does not consider this testimony material to its case, but is offering it merely to show the inconsistent position which the plaintiff has taken, and contends and will contend that without it there is a failure of proof, as far as the plaintiff is concerned."

XI. The Court erred in refusing to receive in evidence Circular No. 12-E of the Interstate Commerce Commission, Case 537 thereof, stating the rules of the said Commission as to what account special taxes assessed on the property of a carrier for the cost of the construction of public improvements should be charged: (a) when the

property is used for operating purposes; and (b) when such property is not used for operating purposes. Such refusal was erroneous, because the defendant had attacked certain accounting statements offered by the plaintiff, on the ground that in those statements taxes assessed for local benefits were charged to operating expenses, and the said circular of the Interstate Commerce Commission showed how such taxes were charged.

XII. The Court erred in overruling the plaintiff's objection to the following question propounded to C. P. Lincoln, an accountant in the employ of the said Railway Company, the question referring to a charge to Profit and Loss, for the year in which certain bonds of the said Railway Company were sold, of the total discount on the sale of the said bonds, viz.:

"So it has always been your policy to charge off the discount and floating expenses before you really suffered the loss?"

Such ruling was erroneous, for the reasons stated in the plaintiff's objection, viz.: that the question did not constitute proper cross-examination and was erroneous, immaterial and argumentative.

Wherefore, the plaintiff prays that the judgment of the said District Court in this cause may be reversed, and that it may have such other and further relief as may be just.

GORDON M. BUCK,
Attorney for Plaintiff, 165 Broadway,
Manhattan, City of New York, N. Y.

The foregoing Assignment of Errors was duly presented to me this 15th day of March, 1917, before the allowance of the Writ of Error herein from the Supreme Court of the United States.

MARTIN T. MANTON,
United States District Judge.

[Endorsed:] L-14-300. United States District Court for the Southern District of New York. Southern Pacific Company, Plaintiff, against John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, Defendant. Petition and Assignment of Errors. Gordon M. Buck, Attorney for Plaintiff, No. 165 Broadway, Borough of Manhattan, City of New York. Filed Mar. 15, 1917, U. S. District Court, S. D. of N. Y.

United States District Court, Southern District of New York.

L-14. 300.

SOUTHERN PACIFIC COMPANY, Plaintiff,
against

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for
the Second District of New York, Defendant.

Know all men by these presents, That the Fidelity and Deposit Company of Maryland, having an office and principal place of business for the State of New York at No. 120 Broadway, in the Borough of Manhattan, in the City of New York, is held and firmly bound unto John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, in the sum of two hundred and fifty dollars (\$250), to be paid to the said John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, his successors or assigns, for which payment, well and truly to be made, the said Fidelity and Deposit Company of Maryland binds itself, its successors and assigns, firmly by these presents.

Sealed with its seal. Dated this Fourteenth day of March, Nineteen hundred and seventeen.

Whereas, the above named Southern Pacific Company has prosecuted a writ of error to the United States Supreme Court to reverse the judgment directing a verdict for defendant entered herein on the 14th day of March, 1917.

Now, therefore, the condition of this obligation is such, that if the above named Southern Pacific Company shall prosecute its writ of error to effect and answer all costs if it fails to make its plea good, then this obligation to be void, otherwise the same shall be and remain in full force and virtue.

FIDELITY AND DEPOSIT COMPANY
OF MARYLAND,
By JAMES R. KINGSLEY, *Attorney-in-Fact.*

Attest:

[SEAL.] ERNEST L. HICKS,
Attorney-in-Fact.

Form 105—Revised. 2,000. 1-28-'17.

STATE OF NEW YORK,
County of New York, ss:

On the 14th day of March, in the year 1917, before me personally came James R. Kingsley, to me known, who, being by me duly sworn, did depose and say, that he resides in the City of New York; that

he is the Attorney-in-Fact of the Fidelity and Deposit Company of Maryland, the corporation described in, and which executed the within instrument; that he knows the seal of said corporation; that the seal affixed to said instrument was such corporate seal; that it was so affixed by order of the Board of Directors of said corporation, and that he signed his name thereto by like order; and that the Fidelity and Deposit Company of Maryland has been duly authorized to transact business in the State of New York, in pursuance of the statutes in such case made and provided; and that the liabilities of said Company do not exceed its assets as ascertained in the manner provided in Section 183, of the Insurance Law, constituting Chapter 33 of the Consolidated Laws of the State of New York. And the said James R. Kingsley further said that he is acquainted with Ernest L. Hicks and knew him to be the Attorney-in-Fact of said Company; that the signature of the said Ernest L. Hicks subscribed to the within instrument, was in the genuine handwriting of the said Ernest L. Hicks and was subscribed thereto by like order of the Board of Directors, and in the presence of him, the said James R. Kingsley.

[SEAL.]

F. A. MASSEY,

Notary Public, New York County, No. 65.

At a regular meeting of the Board of Directors of the Fidelity and Deposit Company of Maryland, held in its office in the City of Baltimore, State of Maryland, on the 4th day of October, 1911, the following resolution was unanimously adopted:

"Resolved, That Henry B. Platt, Vice-President, James R. Kingsley, Attorney, Frank H. Platt, Edward T. Platt, Joseph A. Flynn, Hugh M. Allwood, Charles V. R. Marsh, Ernest L. Hicks and Frank A. Eickhoff, all of the City of New York, State of New York, be and each of them is hereby appointed Attorney-in-Fact of this Company and empowered to execute and deliver and attach the seal of the Company to any and all bonds or undertakings for or on behalf of this Company, in its business of guaranteeing the fidelity of persons holding places of public or private trust and the performance of contracts other than insurance policies, and executing or guaranteeing bonds or undertakings required or permitted in all actions or proceedings, or by law required, permitted or allowed.

"Such bonds or undertakings to be executed for the Company by any one of the said Henry B. Platt, James R. Kingsley, Frank H. Platt, Edward T. Platt, Joseph A. Flynn, Hugh M. Allwood, Charles V. R. Marsh, Ernest L. Hicks or Frank A. Eickhoff, and to be attested in every instance by one other of the said Attorneys-in-Fact, as occasion may require."

COUNTY OF NEW YORK, ss:

I, Ernest L. Hicks, Attorney-in-Fact of the Fidelity and Deposit Company of Maryland, have compared the foregoing Resolution with the original thereof, as recorded in the Minute Book of said Company and do hereby certify that the same is a true and correct tran-

script therefrom, and of the whole of the said original Resolution. Given under my hand and the seal of the Company, at the City of New York, this 14th day of March, 1917.

[SEAL.]

ERNEST L. HICKS,
Attorney-in-Fact.

Fidelity and Deposit Company of Maryland.

Statement December 31, 1916.

Assets.

Home Office Building and Annex.....	\$2,600,000.00
Other Real Estate	94,848.59
Bonds and Stocks	6,325,004.25
First Mortgage Loans, etc.	414,807.06
Unpaid Premiums (subsequent to Oct. 1, 1916) ..	1,183,222.31
Unpaid Premiums (prior to Oct. 1, 1916).....	389,748.37
Bank Deposits for use of Branch Offices, etc.....	73,800.00
Cash in Banks and Trust Companies.....	1,401,770.79

Total Assets.....	12,483,201.39
-------------------	---------------

(Assets deducted according to ruling and regulations of various Insurance Departments, etc.)

Unpaid Premiums, prior to Oct. 1, 1916)	\$389,748.37	
Net amount of Special Deposits made under laws of various States, etc..	258,806.17	
		648,554.54

Total Assets (on basis of statement to Insurance Departments, etc.)	11,834,646.85
---	---------------

Liabilities.

Reserve for Unearned Premiums.....	\$3,263,734.21
Reserve for Claims, Admitted and Unadmitted....	2,215,044.15
Reserve for Advance Premiums and Return Premiums	209,345.65
Reserve for Commissions (Unpaid Premiums subsequent to Oct. 1, 1916).....	204,782.45
Reserve for Premium Taxes, and Expenses in Transit	145,000.00
Reserves, Special and Contingent	498,365.61
Reserve for Unpaid Reinsurance Premiums.....	98,912.09

Capital Stock, Paid up in Cash	\$3,000,000.00	
Surplus and Undivided Profits	\$2,878,017.23	
Less amount <i>de</i> deducted, according to Insurance Department regulations (See above)	648,554.54	
Surplus and Undivided Profits (on basis of statement to Insurance Departments, etc.)	2,229,462.69	
		5,229,462.69
		<u>\$11,884,646.85</u>

STATE OF NEW YORK,
County of New York, ss:

Ernest L. Hicks being duly sworn, says that he is the Attorney-in-Fact of the Fidelity and Deposit Company of Maryland, that the foregoing is a true and correct statement of the financial condition of the said Company, as of December 31, 1916, to the best of his knowledge and belief, and that the financial condition of said Company is as favorable now as it was when such statement was made.

ERNEST L. HICKS.

Subscribed and sworn to before me, this 14th day of March, 1917.

F. A. MASSEY,
Notary Public, New York County.

[Endorsed:] U. S. District Court, Southern Dist. of New York. Southern Pacific Company, Plaintiff, against John Z. Lowe, Jr., U. S. Collector, etc. Copy. Bond. Filed Mar. 15, 1917. U. S. District Court, S. D. of N. Y. I approve of the within Bond and of the sufficiency of the surety therein. Dated March 15, 1917. M. T. M., U. S. D. J. Fidelity and Deposit Company of Maryland, 120 Broadway, New York.

United States District Court, Southern District of New York.

L-14. 300.

SOUTHERN PACIFIC COMPANY, Plaintiff,
against

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for the Second District of New York, Defendant.

This 15th day of March, 1917, comes the Southern Pacific Company, plaintiff above named, by its attorney, and files herein and

presents to the Court its petition praying for the allowance of a Writ of Error and an Assignment of Errors intended to be urged by it, praying also that a transcript of the record and proceedings and papers upon which the judgment herein was rendered, duly authenticated, may be sent to the Supreme Court of the United States, and that such other and further proceedings may be had as are proper in the premises.

On consideration whereof the Court does allow the Writ of Error upon the plaintiff giving bond according to law in the sum of \$250.00, which shall operate as a supersedeas bond.

MARTIN T. MANTON,
U. S. D. J.

[Endorsed:] United States District Court for the Southern District of New York. Southern Pacific Company, Plaintiff, against John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, Defendant. Order. Gordon M. Buck, Attorney for Plaintiff, No. 165 Broadway, Borough of Manhattan, City of New York. Filed Mar. 15, 1917. U. S. District Court, S. D. of N. Y.

Stipulation on Appeal Record.

United States District Court, Southern District of New York.

L-14. 300.

SOUTHERN PACIFIC COMPANY, Plaintiff,

v.

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for the Second District of New York, Defendant.

It is hereby stipulated and agreed, that the foregoing is a true transcript of the record of the said District Court in the above-entitled matter as agreed on by the parties.

Dated March 16, 1917.

GORDON M. BUCK,
Attorney for Plaintiff.
H. SNOWDEN MARSHALL,
Attorney for Defendant.

[Endorsed:] United States District Court, Southern District of New York. Southern Pacific Company, Plaintiff, v. John Z. Lowe, Jr., United States Collector of Internal Revenue for the Second District of New York, Defendant. Stipulation as to Correctness of Appeal Record. Gordon M. Buck, Attorney for Plaintiff, 165 Broadway, Borough of Manhattan, City of New York.

UNITED STATES OF AMERICA,
Southern District of New York, ss:

L-14. 300.

SOUTHERN PACIFIC COMPANY, Plaintiff,

v.

JOHN Z. LOWE, JR., United States Collector of Internal Revenue for
the Second District of New York, Defendant.

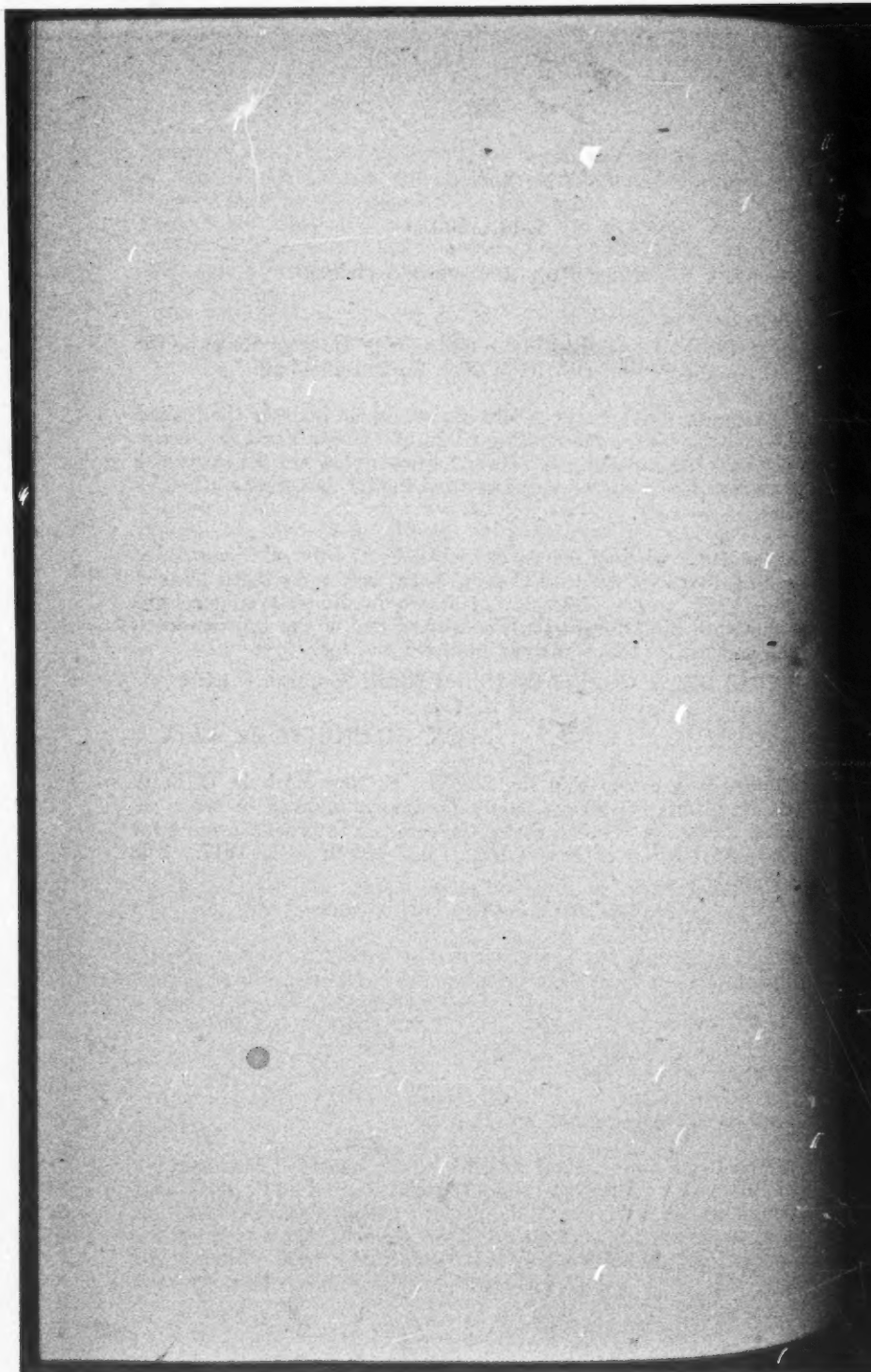
I, Alexander Gilchrist, Jr., Clerk of the District Court of the United States of America for the Southern District of New York, do hereby Certify that the foregoing is a correct transcript of the record of the said District Court in the above entitled matter as agreed on by the parties.

In testimony whereof, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, this — 16th day of March in the year of our Lord one thousand nine hundred and seventeen and of the Independence of the said United States the one hundred and forty-first.

[Seal District Court of the United States, Southern District
of N. Y.]

ALEX. GILCHRIST, JR., Clerk.

Endorsed on cover: File No. 25,851. S. New York D. C. U. S.
Term No. 1021. Southern Pacific Company, plaintiff in error, vs.
John Z. Lowe, Jr., United States Collector of Internal Revenue for
the Second District of New York. Filed March 24th, 1917. File
No. 25,851.



In the Supreme Court of the United States.

OCTOBER TERM, 1917.

SOUTHERN PACIFIC COMPANY, PLAINTIFF

IN ERROR,

v.

JOSEPH Z. LOWE, JR., UNITED STATES

COLLECTOR OF INTERNAL REVENUE FOR

THE SECOND DISTRICT OF NEW YORK.

No. 452.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES
FOR THE SOUTHERN DISTRICT OF NEW YORK.

MOTION ON BEHALF OF DEFENDANT IN ERROR TO DISMISS AND BRIEF IN SUPPORT.

Now comes the Solicitor General, and, on behalf of the defendant in error, moves to dismiss the writ of error in the above-entitled cause for lack of jurisdiction.

BRIEF IN SUPPORT OF MOTION.

This writ of error is prosecuted under section 238, Judicial Code, and the only basis claimed for it is that the case is one "that involves the construction or application of the Constitution of the United States," or is one "in which the constitutionality of a law of the United States is drawn in question."

An examination of the record shows clearly, however, that the case (a) either does not involve the Constitution of the United States in the sense required by the uniform decisions of this court, but involves merely the construction of Section II, subsection A, subdivisions 1, 2, and subsection B, of the act of October 3, 1913, 38 Stat. 114, 166, 167, or (b) raises a constitutional question which has been so recently and completely determined by decisions of this court as to be frivolous.

The complaint in the cause contained two counts (R. a2, a9), but, by stipulation between the parties, only the second count was litigated, the first being held to await the outcome of the trial of the second (R. a18). As to the second count it appeared that during the taxing year 1914 the Central Pacific Railway Company and the Reward Oil Company paid certain dividends to their stockholders of record, of whom the plaintiff in error was one (R. a9, a10). These dividends were not returned by the plaintiff in error as income for said taxing year, and accordingly the defendant in error, as collector, purporting to act under the Income Tax Act of October 3, 1913, and claiming that said dividends were income to the defendant in error under a proper construction of said act, levied an assessment upon the same, which the plaintiff in error paid under protest, and which it now sues to recover back (R. a10, a11, a12). The complaint in addition alleges (R. a10) that the said act did not by its terms impose a tax on the said sum, and that, if

construed as imposing a tax thereon, was unconstitutional and void, as levying a direct tax on capital without an apportionment (R. a10, a11, a12). The reason assigned for this latter claim was that most of these dividends were paid from capital accumulated prior to January 1, 1913, and that the ordinary dividend paid by the Central Pacific Railway Company on June 13, 1914, was in part derived from earnings made prior to said date (R. a10).

(a) It is evident that the substantial, if not the only, question in the case was whether these cash dividends constituted, under a proper construction of the act, income for the year 1914, in which they were declared and paid. No claim was made by anybody that the United States had power under the Constitution to tax capital directly without apportionment. The only question was whether the payment of these cash dividends was a mere readjustment of capital, or whether, on account of the additional advantage derived by the stockholder therefrom, it constituted income. The Constitution may have been appealed to as an aid in the construction of the statute, but the case turned nevertheless upon that construction, and an error made by the court in interpreting the statute must be corrected in the manner provided by law. The constitutionality of the act of October 3, 1913, in so far as it levied a tax on incomes could not, of course, be drawn in question by anybody since the decision of this court in *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1. The question as to what is "income,"

and what is "capital" is, it is true, still open in every case, but that is a question to be determined by a construction of the statute and does not, in any true sense, involve the Constitution. Nor does the statement in the complaint that the Constitution is involved and that the constitutionality of a law of the United States is drawn in question help matters. *Lampasas v. Bell*, 180 U. S. 276, 282; *Arbuckle v. Blackburn*, 191 U. S. 405, 415. This proceeding, therefore, is merely an attempt to avoid the legal, commonplace steps of a writ of error from the Circuit Court of Appeals with a right to apply to this court for a certiorari.

It is submitted that the case falls directly within the rule laid down in the following decisions of this court: *Cornell v. Green*, 163 U. S. 75, 78, 80; *Lampasas v. Bell*, *supra*; *Arbuckle v. Blackburn*, *supra*; *Cosmopolitan Mining Co. v. Walsh*, 193 U. S. 460, 471, 472; *Sloan v. United States*, 193 U. S. 614, 620; *Taylor v. Taft*, 203 U. S. 461, 464; *American Sugar Refining Co. v. United States*, 211 U. S. 155, 161, 162; *Rakes v. United States*, 212 U. S. 55, 58; *Childers v. McClaughry*, 216 U. S. 139; *Norton v. Whiteside*, 239 U. S. 144, 147; *Lamar v. United States*, 240 U. S. 60, 65; *Chin Fong v. Backus*, 241 U. S. 1, 5.

Certain of the more significant of these cases may properly be referred to more specially. In *Arbuckle v. Blackburn*, 191 U. S. 405, the dairy and food commissioner of the State of Ohio ruled that the plaintiff's product was adulterated within the meaning of the State pure food act, and did not come

within the proviso exempting articles not injurious to health. It was claimed that if this construction was correct it would render the act unconstitutional. This court dismissed the appeal for the reason that no constitutional question was involved, and said (p. 415):

The suggested controversy was purely hypothetical and based the supposed constitutional objections on the contingency that, on issues of fact, it might be judicially determined that Ariosa came within the statute, which complainants denied.

If the commissioner's conclusions were erroneous, the courts were open for the correction of the error, and the possibility that they might agree with the commissioner could not be laid hold of as tantamount to an actual controversy as to the effect of the Constitution, on the determination of which the result of the present suit depended. Indeed, in the only case called to our attention by counsel, involving the status of Ariosa, the court of common pleas of Lucas County, Ohio, held that it was not within the prohibition of the statute. *White v. Ohio*, 12 Ohio Nisi Prius Decisions, 659.

Reference to the Constitution to strengthen objections to a particular construction, or the pursuit of a certain course of conduct, is not sufficient to invoke jurisdiction. * * *

In *Cosmopolitan Mining Co. v. Walsh*, 193 U. S. 460, it was claimed that the plaintiff in error had been deprived of its property without due process of law contrary to the Constitution of the United

States, because the statute of Colorado when properly construed permitted a judgment to be rendered against it without proper service. The writ of error was dismissed for lack of jurisdiction, the court saying (pp. 471, 472):

It is obvious, under the construction of the judiciary act of 1891, announced in the cases just referred to, that this cause does not involve the construction or application of the Constitution of the United States, and therefore was not entitled to be brought directly to this court from the Circuit Court of the United States. When the proceedings at the trial are taken into view it is clear that the contentions which were urged did not require the construction of the Constitution of the United States, but simply called for the construction of the constitution and laws of the State of Colorado or the application of the principles of general law. * * *

* * * The claim asserted under the Constitution of the United States was, therefore, merely conjectural and amounted to this only, that if under the law of Colorado or under the general law the service on the alleged agent was void, that it would be a violation of the Constitution of the United States to give effect to judgments based on such service. Not only the statement we have made from the record, but the argument at bar, makes this a demonstration. Thus, in the discussion at bar, it was stated that it was not claimed that the State of Colorado could not without a violation of the Constitution of the

United States have exacted that the authority conferred by a foreign corporation upon an agent to receive service of process should continue for the purpose of the enforcement of obligations contracted by the corporation, although the corporation had ceased to do business within the State, but that as the Colorado law when properly construed did not so provide, therefore the service was invalid, and the sale of the property of the mining company based on such service was void. This, however, as we have already shown, amounts but to the concession that the substantial controversy which the case presented involved the mere determination of what was the law of Colorado on the subject. The rulings of the court below as to the admissibility of evidence and its final direction of a verdict involved necessarily deciding that the service upon the agent was valid by the law of Colorado, or the principles of general law applicable thereto, and its action in so doing in nowise involved the construction or application of any provision of the Constitution of the United States.

In *Sloan v. United States*, 193 U. S. 614, the complainants brought suit for the purpose of maintaining their rights to certain allotments to Indians granted by a law of the United States. The act itself referred to a treaty of 1865 between the United States and the Omahas, and both the complainant and the United States referred to this and other treaties as part of their case. The appeal was dismissed on

the ground that the construction of the treaties was not involved within the meaning of section 238 of the Judicial Code, the court saying (pp. 620, 621):

* * * The construction of a treaty is used only as an argument upon the issue directly in question, viz, the construction of the statute. The alleged right to an allotment being based upon the act of 1882, and the defense being also based upon the proper construction of that act, we cannot but regard the case as one simply resting on such act. The construction of these various treaties was not substantially or in any other than a merely incidental or remote manner drawn in question, and therefore a direct appeal to this court cannot be sustained.

* * * * *

* * * In order to come within the act of 1891 the treaty must be directly involved, and upon its construction the rights of the parties must rest. Within these cases it cannot be said that the construction of any treaty is drawn in question herein when the rights of neither party are necessarily dependent upon such construction, but are dependent upon that which may be given the statute of 1882, and when the construction of that statute is independent of that which may be given any of the treaties mentioned, although weight may be given to the treaties in determining the question of the construction of the statute.

In *American Sugar Refining Co. v. United States*, 211 U. S. 155, it was claimed that certain regulations

issued by the Secretary of the Treasury in regard to customs dues on sugar added something not contained therein to the requirements of the act, and in this way constituted an exercise of legislative power in violation of the Constitution. The court, in dismissing the appeal for lack of jurisdiction said (pp. 161, 162):

This is conceded, and counsel for appellant attempt to sustain the jurisdiction on the ground that the regulations assumed to add something to the dutiable standard prescribed by the tariff act, and that in doing so the Secretary exercised legislative power confided by the Constitution solely to Congress. But this does not constitute a real and substantial dispute or controversy concerning the construction or application of the Constitution upon which the result depends.

The admitted duty of the Secretary of the Treasury was to construe as best he could the paragraph relating to collection of duty upon sugars, and to promulgate regulations for carrying it into effect. Rev. Stat. § 251. This and this alone he did. The only real substantial point involved is whether or not he misconstrued the statute, and that gives this court no jurisdiction upon direct appeal. *Sloan v. United States*, 193 U. S. 614, 620, and cases cited; *United States ex rel. Taylor v. Taft, Secretary*, 203 U. S. 461.

Undoubtedly Congress, without violating any constitutional provision, could have in terms directed exactly what was prescribed by the Treasury regulations; and prior decisions

have held that the statute was properly construed by the Secretary.

We concur with counsel for the Government that if the construction or application of the Constitution of the United States, within the meaning of § 5, act of 1891, is involved in every case where one claims that according to his interpretation of a statute excessive duty or tax has been demanded by executive officers, the provisions of that act making decisions of the Circuit Court of Appeals in revenue cases final are of very limited value, and this court must entertain direct appeals from the Circuit Courts in most tariff and tax controversies, which we regard as out of the question.

(b) The claim made in paragraphs 13 and 16 of the complaint (R. all, a12) that a tax properly levied upon income under the provisions of the act of October 3, 1913, becomes unconstitutional if the income be derived from capital accumulated prior to January 1, 1913, is wholly frivolous, the point having been determined by this court adversely to the claim in *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1; *Stanton v. Baltic Mining Co.*, 240 U. S. 103, and *Edwards v. Keith*, 231 Fed. 110, writ of certiorari denied, 243 U. S. 638.

It is noteworthy that the complaint lays equal stress upon the point that the tax was imposed upon income received *prior to October 3, 1913*, as indicating its unconstitutionality (R. a8, par. 5, R. all, par. 13). Clearly, therefore, the pleader correctly assumed that

the argument against the constitutional validity of a tax upon incomes accruing prior to October 3, 1913, was the same as the argument against the constitutional validity of the tax on incomes accruing from capital accumulated prior to January 1, 1913; namely, that incomes received prior to October 3, 1913, had become capital prior to the passage of the act and to tax them would be to tax retroactively capital without apportionment. This argument, however, was the very one made to this court and overruled in *Brushaber v. Union Pacific R. R. Co.*, *supra*.

It is submitted, therefore, that the writ of error in the present case should be dismissed for lack of jurisdiction.

JOHN W. DAVIS,
Solicitor General.

NOVEMBER, 1917.

INDEX.

	PAGE
Statement of Facts.....	1
I. Constitutional questions here presented have never been determined	4
(1) Congress has no power to tax without apportionment income accruing prior to Sixteenth Amendment.....	4
(2) Statute as construed would produce such inequality and hardship as to render it unconstitutional.....	17
(3) Foregoing Constitutional questions were properly raised in lower Court and adversely decided.....	19
(4) These Constitutional questions have not been decided by this Court	22
II. The case involves the construction of the Constitution of the United States	23

TABLE OF CASES.

American, &c., Co. v. U. S., 211 U. S., 155, 161.....	35
Arbuckle v. Blackburn, 191, U. S., 405.....	31
Bailey v. R. Co., 106 U. S., 109.....	15, 34
Bridge Proprietors v. Hoboken Co., 1 Wall., 116, 143.....	29
Brushaber v. R. Co., 240 U. S., 118.....	1, 5, 7, 18
Chapman v. Goodnow, 123 U. S., 540, 548.....	28
Chicago Life Ins. Co. v. Needles, 113 U. S., 574, 579.....	28
Collector v. Hubbard, 12 Wall., 1, 17.....	15
Cosmopolitan Mining Co. v. Walsh, 193 U. S., 460, 472.....	32
County of San Mateo v. R. Co., 13 Fed., 145, 150.....	19
Darnell v. R. Co., 206 Fed., 445 (C. C. A.).....	37
Edwards v. Keith, 231 Fed., 110.....	13
Fayerweather v. Rich, 195 U. S., 276, 299.....	29
Flint v. Stone Tracy Co., 220 U. S., 107, 162.....	11
G. H. & S. A. Ry. v. Texas, 210 U. S., 217, 227.....	10
Lampasas v. Bell, 180 U. S., 276, 283.....	22
Merchants Ins. Co. v. McCartney, 1 Lowell, 447 (Fed. Cas. 9443)	34
Mobile & Ohio R. Co. v. Tennessee, 153 U. S., 486, 492.....	26
Osborn v. Bank, 9 Wheat., 738, 820.....	28
Penn Mutual L. Ins. Co. v. Austin, 168 U. S., 685, 695.....	31
Pollock v. Trust Co., 157 U. S., 439.....	5, 12, 19
Pollock v. Trust Co., 158 U. S., 601.....	5, 10
Reynolds v. McArthur, 2 Pet., 417, 434.....	6

	PAGE
Reynolds v. Williams, 4 Biss., 108; Fed. Cas., No. 11734.....	24
Savings Society v. Coite, 6 Wall., 594, 609.....	18
Sloan v. U. S., 193 U. S., 614, 621.....	34
Southern R'way. Co. v. Greene, 216 U. S., 400, 417.....	19
Stanton v. Baltic Mining Co., 240 U. S., 103.....	12
Stockdale v. Ins. Co., 20 Wall., 323.....	16
Stratton's Independence v. Howbert, 231 U. S., 399.....	10, 11
Tyce Realty Co. v. Anderson, 240 U. S., 115, 117.....	8
U. S. v. American &c. Co., 202 U. S., 563.....	6
U. S. v. Barr, 159 U. S., 78.....	6
Vicksburg v. Waterworks Co., 202 U. S., 453, 459.....	26
Wiley v. Sinkler, 179 U. S., 58.....	22
Wilmington &c. R. Co. v. Alsbrook, 146 U. S., 279, 293.....	27

OTHER AUTHORITIES.

Black on Income Taxes (2nd Ed.), Sec. 212.....	9, 10
8 Cyc., 731 and 745.....	6
Report of Senate Committee on Tariff Bill. (Senate Rep., No. 80, 63rd Cong., 1st Sess.).....	9

STATUTES CITED.

Constitution, Art. I, Sec. 2, Third Clause.....	4, 21
Constitution, Art. I, Sec. 8.....	4
Constitution, Art. I, Sec. 9, Fourth Clause.....	4, 21
Fifth Amendment.....	20, 21
Fourteenth Amendment.....	4, 21
Sixteenth Amendment.....	4, 20, 21
Income Tax Act of 1916, Sec. 10.....	17
Income Tax Act of 1917, Sec. 1711.....	17
13 Stat. L., 281, Sec. 117.....	15
16 Stat. L., 257, Sec. 7.....	15
Judicial Code, Sec. 238.....	23

Supreme Court of the United States,

OCTOBER TERM, 1917.

No. 452.

SOUTHERN PACIFIC COMPANY,
Plaintiff in Error,

v.

JOHN Z. LOWE, JR., United States
Collector of Internal Revenue
for the Second District of New
York.

BRIEF OF PLAINTIFF IN ERROR

**In Opposition to Motion to Dismiss for
Lack of Jurisdiction.**

STATEMENT OF FACTS.

The principal constitutional question involved in this case is whether or not the Sixteenth Amendment to the Constitution of the United States permits a tax to be levied without apportionment on income that accrued prior to the adoption of that amendment. This question is much more far-reaching than the decision in *Brushaber v. Union Pacific Railroad Company*, 240 U. S., 1, which determined that an income tax might be given a retroactive effect to the extent of taxing without apportionment income that

had accrued a few months prior to the enactment of the statute, but subsequent to the adoption of the amendment. The facts are as follows:

The Central Pacific Railway Company is one of the subsidiary corporations of the Southern Pacific Company, the plaintiff below (the former corporation being hereafter referred to as the "Railway Company" and the latter as the "Plaintiff").

The Plaintiff and its subsidiary corporations, including the Railway Company, form a unified transportation system. The earnings of all the companies are kept together, the Plaintiff acting as the banker of the system (R., 97-98). The Railway Company has no bank account, but its earnings are deposited in the Plaintiff's bank accounts (R., 37, 73). If the Railway Company needs moneys for additions and betterments or other purposes, the necessary funds are advanced by the Plaintiff (R., 73-74, 97, 102). Proper entries are made on the books of the two corporations, but as a practical matter no distinction is made as to the ownership of the funds (R., 35, 100-103). The Plaintiff is and has been the lessee of the railroads and appurtenant properties of the Railway Company at all times since the incorporation of the latter in the year 1899 (R., 5, 152). In other words, the Plaintiff has had possession, not only of the moneys of the Railway Company, but of nearly all of its other assets. The Plaintiff has also continuously owned the entire

capital stock of the Railway Company ever since the latter's incorporation (R., 5).

In December, 1913, the Railway Company determined to distribute its entire surplus, all of which had been accumulated prior to July 1, 1909, and all of which, as we have seen, was already in the Plaintiff's possession. This distribution was effected by the payment of a number of dividends in the first six months of the year, 1914, but the bulk of the surplus was distributed by two extraordinary dividends of twenty per cent. each, declared on the common and preferred stock of the Railway Company in December, 1913, and paid in January, 1914. These two dividends aggregated \$16,935,100 (R., 150, 171). The payment of the dividends was constructive merely (R., 74, 125), and was effected by book entries by means of which the indebtedness due from the Plaintiff to the Railway Company was partially liquidated (R., 35-37). As the Plaintiff had continuously owned the Railway Company's entire capital stock ever since the latter's incorporation, the Plaintiff was made neither richer nor poorer by the declaration and payment of these dividends.

In making its income tax return for the six months' period ending June 30, 1914, the Plaintiff, because of the Treasury decisions on the subject and in order to show the utmost good faith, appended a foot-note stating that it had excluded from the statement of its gross income all dividends received by it from its subsidiary corpora-

tions which had been accumulated by the latter prior to January 1, 1913 (R., 141). The Commissioner of Internal Revenue made an additional assessment upon the dividends so excluded, and the tax was paid under protest (R., 4). This action was instituted to recover the tax so paid; and a verdict was directed in favor of the defendant (R., 138).

POINT I.

The constitutional questions presented in this case have never been determined.

Two constitutional questions are presented:

(1) Congress has no power to impose a tax without apportionment upon income accruing prior to the adoption of the Sixteenth Amendment, and the Income Tax Act of 1913 is unconstitutional, if given such a construction.

The Federal Constitution requires direct taxes to be apportioned among the several States according to population (Art. I, Sec. 2, Third Clause, as amended by Fourteenth Amendment; and Art. I, Sec. 9, Fourth Clause); while an excise tax must "be uniform throughout the United States" (Art. I, Sec. 8). The language of the Sixteenth Amendment is as follows:

"The Congress shall have power to lay

and collect taxes on *income*, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Prior to the decision in *Pollock v. Trust Company*, 157 U. S., 429, and 158 U. S., 601, income taxes had generally been considered as indirect or excise taxes. (See historical resumé in that case and in *Brushaber v. R. Co.*, 240 U. S., 1.) In the *Pollock* case, however, it was settled that a tax on income derived from real or personal property was a direct tax and not an excise tax; and, therefore, in order to be valid must be apportioned according to population.

All of the Railway Company's income is derived from real or personal property. All of its railroads and appurtenances are leased to the Plaintiff, and its chief source of income is the rental derived therefrom. The surplus from which the dividends here in question were paid arose from this source and from the sale of its granted lands and other capital assets. Hence, the tax here sought to be recovered falls clearly within the decision of the *Pollock* case, holding such taxes to be direct.

Almost all capital results from the saving of income. As income is received and invested, it becomes capital. The income of the Railway Company has been invested in additions and betterments to its railroad properties. Long prior

to the adoption of the Sixteenth Amendment, the surplus out of which these dividends were paid had become capital. The Sixteenth Amendment was not designed to permit the imposition of a tax on capital under the guise of an income tax. If all property that had once been income could now be made subject to an income tax, nearly all the capital of the country could be subjected to a direct tax without apportionment. This would practically abrogate the Constitutional limitation requiring apportionment.

A limited degree of retroactivity may, perhaps, be given to an unapportioned income tax law enacted by Congress since the adoption of the Sixteenth Amendment, if the intention to make the law retroactive is explicitly stated; but there must be apportionment if the law seeks to tax income derived from real or personal property prior to the amendment. For Congress was limited by the rule of apportionment until the amendment became effective, and a cardinal rule of construction requires a prospective operation to be given to Constitutional amendments.

8 Cyc., 731 and 745, and cases cited;

See also:

U. S. v. Burr, 159 U. S., 78;

U. S. v. American Sugar Refining Company, 202 U. S., 563.

In *Reynolds v. M'Arthur*, 2 Pet., 417, 434, Chief

Justice Marshall referred to a retrospective construction of a statute as "odious," and said:

"It is a principle which has always been held sacred in the United States, that laws by which human action is to be regulated look forward, not backwards; and are never to be construed retrospectively, unless the language of the Act shall render such construction indispensable."

In *Brushaber v. R. Co.*, 240 U. S., 1, 18, the court said (White, C.J.):

"Indeed in the light of the history which we have given and of the decision in the *Pollock Case*, and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the [Sixteenth] Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock Case* was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment."

The Income Tax Act of 1913 made no provision for apportionment; and although it was enacted October 3, 1913, and imposed an income tax from the first day of the preceding March, its constitutionality was upheld. The court was, however, careful to limit its decision by saying:

"But the date of the retroactivity did not extend beyond the time when the amendment was operative, and there can be no dispute that there was power by virtue of the amendment during that period to levy the tax without apportionment, and so far as the limitations of the Constitution in other respects are concerned, the contention is not open."

In *Tyee Realty Company v. Anderson*, 240 U. S., 115, 117, the merits of the contention there raised were not discussed by the court—

"because each and all of them were considered and adversely disposed of in *Brushaber v. Union Pacific Railroad*."

Except the two just cited, no other case has yet been decided by this court in which the question of retroactivity was involved; and in both of those cases the retroactivity covered only a portion of a year, and there had been no attempt to tax income accruing prior to the Sixteenth Amendment. Perhaps in those cases it would be more accurate to say that there was no retroactivity,

"for the year's income is treated and con-

sidered as one entire thing, and not as made up of several portions or items."

Black on Income Taxes (Second Edition), Sec. 212 and cases cited.

The Sixteenth Amendment authorizes the imposition, without apportionment, of a tax only on income, not on capital. An unapportioned tax may now be measured by income accruing during a limited period prior to the passage of the tax law, provided the income has accrued subsequent to the Sixteenth Amendment; but the moment this law seeks to tax income that has accrued prior to the amendment, it is a tax on capital, and, not falling within the terms of the amendment, is repugnant to the Constitution. The report of the Senate Committee on the Tariff Bill (Senate Report No. 80, 63rd Congress, First Session) recognized the invalidity of an unapportioned tax on income accrued prior to the Sixteenth Amendment, by stating that the law had been "amended to obviate the Constitutional objection to computing the tax on income accruing prior to the date on which the amendment to the Federal Constitution authorizing the tax went into effect."

In the case at bar, can the Treasury officials disregard the large surplus that had accrued prior to the Sixteenth Amendment, and by so doing make that income which is not income within the true meaning of the term? A tax on capital cannot be made an income tax simply by denominat-

ing it as such. As was said by Mr. Justice Holmes in *G. H. & S. A. Ry. v. Texas*, 210 U. S., 217, 227, where the question involved was whether or not a tax was a burden upon interstate commerce:

“Neither the state courts nor the legislatures by giving the tax a particular name or by the use of some form of words, can take away our duty to consider its nature and effect.”

Other authorities which hold that a tax may be imposed on income accruing prior to the enactment of the statute laying the tax, are either decisions arising under State income tax laws, which are not restricted by the provisions of the Federal Constitution (Black on Income Taxes, Second Edition, Sec. 212), or they are decisions in regard to excise taxes. In the latter class of cases the tax is not imposed upon income, but measured by income, and being an indirect tax, it is freed from Constitutional restrictions in regard to apportionment.

An excise tax is an indirect tax measured by income, and may be imposed with or without apportionment, regardless of the Sixteenth Amendment; while a tax on income derived from real or personal property prior to the adoption of the Sixteenth Amendment is a direct tax, and a direct tax cannot be imposed unless so apportioned.

Stratton's Independence v. Howbert, 231 U. S., 399;

Pollock v. Trust Company, 158 U. S., 601.

In *Stratton's Independence v. Howbert*, *supra*, a case involving the construction of the Corporate Excise Tax Act of 1909, Mr. Justice Pitney said:

"As to what should be deemed 'income' within the meaning of Section 38, it, of course, need not be such an income as would have been taxable as such, for at that time (the Sixteenth Amendment not having been yet ratified) income was not taxable as such by Congress without apportionment according to population, and this tax was not so apportioned."

As an excise tax may be measured by income that has accrued before the passage of the law imposing it, so also it may be measured by other income upon which a direct tax could not be constitutionally imposed.

In *Flint v. Stone Tracy Co.*, 220 U. S., 107, 162, the court, in answer to the argument that in certain cases the result of the Corporate Excise Tax Act of 1909 was to impose a tax on non-taxable securities, said that—

"This argument confuses the measure of the tax upon the privilege with direct taxation of the estate or thing taxed. In the *Pollock* case, as we have seen, the tax was held unconstitutional because it was in effect a direct tax."

On the other hand, in *Pollock v. Trust Company*, 157 U. S., 429, 586, the court held the Income Tax Law of 1894 unconstitutional upon the ground, among others, that it imposed a tax upon income derived from municipal securities, saying:

"It is obvious that taxes on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution."

The case of *Stanton v. Baltic Mining Company*, 240 U. S., 103, cited by the defendant in error as determinative of the question presented in the case at bar, has no bearing upon it. There the constitutionality of the Income Tax Act of 1913 was attacked on the ground that the tax it had imposed upon mining companies did not make adequate allowance for depreciation, and hence not only resulted in a tax on the profits derived from the operation of the mine, but also constituted a tax on the mine itself, and, therefore, a tax on capital. In other words, the Mining Company claimed that the sale of the products of the mine constituted to a large extent a conversion of capital assets. The court said (White, C.J.), with regard to this contention (p. 113):

"It moreover rests upon the wholly falla-

cious assumption that looked at from the point of view of substance a tax on the product of a mine is necessarily in its essence and nature in every case a direct tax on property because of its ownership unless adequate allowance be made for the exhaustion of the ore body to result from working the mine. We say wholly fallacious assumption because independently of the effect of the operation of the Sixteenth Amendment it was settled in *Stratton's Independence v. Howbert*, 231 U. S., 399, that such a tax is not a tax upon property as such because of its ownership, but a true excise levied upon the results of the business of carrying on mining operations (pp. 413 *et seq.*)."

The bearing of *Edwards v. Keith*, 231 Fed., 110 (writ of certiorari denied, 243 U. S., 638), another case cited by the defendant in error is equally remote. There it was held that the commissions of an insurance agent were taxable as a portion of the income for the year in which the commissions were received, where the policies had been written by him prior to the effective date of the Income Tax Act, but the premiums upon which the commissions became effective were paid thereafter. In the contract between the insurance company and the agent, it was expressly provided, however, that the commissions were not earned until the premiums were actually paid. If the

policy holders died, or forfeited or surrendered their policies, or for any other reason failed to pay the premiums, then the agent was not entitled to the commissions. Under the circumstances, it was naturally held that the commissions accrued to the insurance agent when they were earned, namely, when the premiums were paid. The court said:

"But the question seems to us a very simple one and one absolutely determined by the provision in all the contracts that 'commissions shall accrue only as the premiums are paid in cash.'

• • • • •

"It may be noted that, although fully earned by work already done, there is no certainty that the sum conditionally promised for an ensuing year will ever be paid or will accrue or come due; John Doe may die within the first year, or at its expiration may refuse to renew his policy, in which event the Company is not obligated to pay its agent anything beyond the amount already paid him; the obligation to pay does not arise until John Doe actually pays his renewal premium in cash" (p. 112).

The question there was very different from that in the case at bar. Here the stock of the Railway Company had increased in value prior to 1909, owing to the existence of the large surplus that was distributed in January, 1914. The Plaintiff

not only had actual possession of the assets of the Railway Company, but as the holder of its entire stock became beneficially entitled to the surplus in question as it was earned; while the insurance agent had no claim, equitable or otherwise, to commissions until the premiums were paid. The one interest was vested, the other speculative and contingent. In the *Keith* case, the commissions were not only received, but actually arose and accrued after the Act became effective. To perceive a resemblance between this case and the case at bar is but a failure to see differences.

It is well settled that for income tax purposes the stockholders of a corporation own the undistributed surplus of their corporations (*The Collector v. Hubbard*, 12 Wall., 1, 17; *Bailey v. R. Co.*, 106 U. S., 109), and under a number of the earlier Federal income tax laws this undistributed surplus has actually been taxed.

16 Stat. L., 257, Section 7;

13 Stat. L., 281, Section 117.

In *The Collector v. Hubbard*, 12 Wall., 1, 17, the court held that stockholders were the owners of the undistributed profits of their corporation and were taxable thereon under the Federal income tax law of 1864. A portion of the opinion is as follows:

“Decided cases are referred to, in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being

declared, and it cannot be doubted that those decisions are correct as applied to the respective subject-matters involved in the controversies. Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made.* Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees."

The decision which is usually cited to sustain retroactive income taxation is *Stockdale v. Insurance Companies*, 20 Wall., 323. That case involved the construction of one of the Federal in-

* *March v. Railroad*, 43 New Hampshire, 520.

come tax laws enacted during the Civil War period, and, as stated by the Chief Justice in the *Brushaber* case, *supra*, it was the practice up to the time of the decision in the *Pollock* case, to treat income taxes as excise taxes. As the tax considered in the *Stockdale* case was then regarded as an excise tax, the court found no objection to its being given a few months' retroactivity. It should also be noticed that the statute which the court was there construing did not impose a new tax *ab initio*, but declared the construction of a prior statute. Two of the justices, in a concurring opinion, held this a more satisfactory ground upon which to place the court's decision, and three of the justices dissented.

(2) The construction of the statute contended for by the Treasury Department would produce such inequality and hardship as to render the Act unconstitutional.

To tax a stockholder on dividends when received, and not when earned, would produce inequality and hardship. Because of the rulings of the Treasury Department under the Act of 1913, both the Act of 1916 and that of 1917 specifically provide that dividends paid from a surplus accruing prior to March 1, 1913, shall not be subject to tax.

Act of 1916, Section 10;
Act of 1917, Section 1211.

The present case well illustrates the hardship and inequality of the Treasury Department's construction, for the Plaintiff has been taxed on some \$20,000,000 of its subsidiary's surplus which the Plaintiff has had possession of for years, merely because a dividend was declared and constructively paid in January, 1914. If, however, the Railway Company had been dissolved and the distribution effected by means of a liquidating dividend, under the rulings of the Treasury Department no tax would have been imposed.

As was said by this court in *Savings Society v. Coite*, 6 Wall., 594, 609:

"Common justice requires that taxation as far as possible should be equal."

In *Brushaber v. R. Co.*, 240 U. S., 1, 24, the court held that "certain numerous and minute, not to say in many respects, hypercritical contentions" did not render the Act repugnant to the Fifth Amendment, but added—

"that this doctrine would have no application in a case where although there was a seeming exercise of the taxing power, the Act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross

and patent inequality as to inevitably lead to the same conclusion."

Mr. Justice Field, in his concurring opinion in the case of *Pollock v. Trust Company*, 157 U. S., 429, 599, said:

"The inherent and fundamental nature and character of a tax is that of a contribution to the support of the Government levied upon the principle of equality and uniform apportionment among the persons taxed and any other exaction does not come within the general definition of a tax.

"This inherent limitation upon the taxing power forbids the imposition of taxes which are unequal in their operation upon similar kinds of property and necessarily strikes down the gross and arbitrary distinctions in the income law as passed by Congress."

Southern Railway Company v. Greene,
216 U. S., 400, 417;

County of San Mateo v. R. Co., 13 Fed.,
145, 150.

(3) The foregoing constitutional questions were properly raised in the lower court and were adversely decided.

The brief of the defendant in error refers to the complaint as alleging that the tax in dispute was levied on income accrued prior to October 3,

1913; but these references are quoted in the complaint from a protest made prior to the decision in the *Brushaber* case. The allegations of the complaint itself are as follows (R. a12):

"The said sum of \$183,882.64 paid by the plaintiff, as hereinbefore set forth, was unlawfully and illegally assessed and collected, as aforesaid, and there existed no warrant in law for the pretended assessment of the said alleged tax against the plaintiff. The said alleged tax was assessed upon income which had arisen and accrued to the plaintiff prior to January 1, 1913, and prior to the adoption of the Sixteenth Amendment to the Constitution of the United States, and which had become capital and was not income subject to tax under the terms of the Income Tax Act; and the Income Tax Act, if and so far as it is construed as imposing a tax thereon, is unconstitutional and void for the reason that it seeks to levy a direct tax in violation of the third clause of Section Two of Article I of the Constitution of the United States and of the fourth clause of Section Nine of said Article, and for the further reason that it imposes unjust and unequal and discriminatory burdens on the plaintiff in violation of the Fifth Amendment to the Constitution of the United States."

These constitutional questions were repeatedly raised in argument during the course of the trial;

and at the conclusion of the trial, in opposition to a motion for the direction of a verdict in favor of the defendant, and in support of a similar motion for a verdict in favor of the Plaintiff, the latter's counsel said (R., 135):

"To give the Act the construction contended for by the defendant would also render it repugnant to the Constitution of the United States, for the following reasons, among others, viz.:

"(a) A direct tax would be imposed without the apportionment required by the Constitution of the United States (Article I, Section 2, Third Clause, as amended by Fourteenth Amendment; and Article I, Section 9, Fourth Clause).

"(b) The tax would be imposed on capital, and not on income, and, therefore, would not be exempted by the Sixteenth Amendment to the Constitution of the United States from the apportionment so required. The Sixteenth Amendment must not be given a retroactive construction.

"(c) The tax would be so unequal in operation as to result in the deprivation of property without due process of law, and as to constitute the taking of private property for public use without just compensation in contravention of the Fifth Amendment to the Constitution of the United States; and

such a construction would also make the Act contravene the implied limitations upon the taxing powers of Congress."

The court directed a verdict for the defendant, and the Plaintiff duly excepted (R., 138).

In order to save the expense of printing the exhibits and to shorten the record, it was stipulated that the protest accompanying the Plaintiff's Return of Net Income, the protest accompanying the payment of the tax, the printed brief submitted to the Commissioner of Internal Revenue in opposition to the additional assessment, and the claim for refund of the tax, "were due and proper, and sufficiently raise and state all the grounds of objection upon which motions for a directed verdict were made by the plaintiff" (R., 4).

(4) The foregoing constitutional questions have not been decided by this court.

In none of the cases cited by the defendant in error could the question of a retrospective construction of the Sixteenth Amendment or the question of the inequality and hardship herein presented have been raised; because none of the parties to those cases had such an interest in these questions as would have justified their presentation to the court for decision.

Lampasas v. Bell, 180 U. S., 276, 283;

Wiley v. Sinkler, 179 U. S., 58.

POINT II.

The case involves the construction of the Constitution of the United States.

Section 238 of the Judicial Code permits a direct appeal to this court from the District Court, where the case is one "in which the constitutionality of any law of the United States * * * is drawn in question" or is one "that involves the construction or application of the Constitution of the United States." Since the District Court held that the tax had been properly levied, this involved the decision that the Income Tax Law of 1913, as construed by the Treasury officials in the case at bar, was correct, and that as so construed it did not violate the Federal Constitution. The constitutional questions, therefore, directly presented were, (1) whether or not the Sixteenth Amendment permitted the levying of such a tax without apportionment, and (2) whether or not the inequality of the tax rendered it repugnant to the terms of the Fifth Amendment.

The defendant's position seems to be that the constitutionality of the Income Tax Act of 1913 has been upheld, and that, therefore, any further question with regard to the Act cannot involve its constitutionality, but merely a construction of its terms. What this court has heretofore decided is that the objections then presented to the constitutionality of the Act were not sound; but these decisions do not authorize the Treasury officials or the trial courts to contend that the Constitution

is not violated no matter what construction they deem proper to place upon the terms of the Act or what effect they are pleased to give it in practical operation.

It is true that the Plaintiff insists that the Income Tax Act of 1913 not only could not constitutionally authorize, but by its terms did not attempt to authorize, the imposition of the tax in controversy.

Bailey v. R. Co., 22 Wall., 604, and 106 U. S., 109;

Reynolds v. Williams, 4 Biss., 108; Fed. Cas. No. 11, 734;

Merchants Insurance Company v. McCartney, 1 Lowell, 447; Fed. Cas. No. 9, 443.

Both the Treasury officials and the trial court have, however, held otherwise. This holding necessarily embodies the decision that the tax imposed does not violate the Constitution. As to the facts the trial court said (R., a19):

“The testimony of the plaintiff’s accountants, together with its books” [the case went to trial upon the plaintiff’s evidence alone], “would indicate that the claim of the plaintiff was well-founded so that it may be assumed that the two extraordinary dividends of twenty per cent. each on the preferred and common stock of the Railway Company, paid in January, 1914, and the extraordinary dividends of \$514,000 likewise paid on the pre-

ferred and common stock in January, 1914, must have been paid wholly out of the surplus accruing prior to July 1, 1909, and that at least \$2,313,234.20 of the six per cent. dividend paid on the common stock in June, 1914, must have been paid out of the surplus accruing prior to July 1, 1909."

As we have seen, the stockholders, for income tax purposes, own the surplus of their corporation (*ante*, pp. 15-16). Hence, the question has been squarely determined by the trial court that the Constitution permits a tax to be levied, without apportionment, on a surplus that accrued long prior to the adoption of the Sixteenth Amendment. It may be—indeed it would seem—that the trial court erroneously assumed that the Government could "not tax undistributed surplus as income to the stockholders because they [sic] were income to the stockholder when paid and not before" (R., a21). Nevertheless, the result is that an unconstitutional tax has been upheld over the Plaintiff's protests specifically calling attention to its unconstitutionality.

Similarly, where a party has claimed that the Constitution has been violated because of the impairment by a State of the obligation of a contract, and the trial court has held that there was no impairment because the contract was not binding, it could be said that no constitutional question was involved, with better grace there than here. With regard to such a state of facts, this

court said, in *Mobile & Ohio Railroad v. Tennessee*, 153 U. S., 486, 492:

"It is contended by counsel for defendants in error that this court is without jurisdiction to review the judgment of the Supreme Court of Tennessee, because it was based, or proceeded, upon the ground that there was no contract in existence between the railroad company and the State to be impaired, * * *

"It is well settled that the decision of a state court holding that, as a matter of construction, a particular charter or a charter provision does not constitute a contract, is not binding on this court. The question of the existence or non-existence of a contract in cases like the present is one which this court will determine for itself, the established rule being that where the judgment of the highest court of a State, by its terms or necessary operation, gives effect to some provisions of the state law which is claimed by the unsuccessful party to impair the contract set out and relied on, this court has jurisdiction to determine the question whether such a contract exists as is claimed, and whether the state law complained of impairs its obligation."

In *Vicksburg v. Waterworks Company*, 202 U. S., 453, 459, the claim of the Waterworks Company that municipal action impaired the obliga-

tion of a contract between it and the City of Vicksburg was sustained and a direct appeal to this court was held proper. On a previous appeal in the same case (185 U. S., 65), it was held that it presented a controversy arising under the Constitution. On the second appeal the court said (Day, J.):

“And it was held in 185 U. S. that the facts taken together presented something more than a case of mere breach of private contract, and disclosed an intention and attempt by subsequent legislation of the city to deprive the company of its rights under the existing contract, and it was said: ‘Unless the city can point to some inherent want of legal validity in the contract, or to some disregard by the Waterworks Company of its obligations under the contract as to warrant the city in declaring itself absolved from the contract, the case presented by the bill is within the meaning of the Constitution of the United States and within the jurisdiction of the Circuit Court as presenting a Federal question.’ ”

Wilmington, &c., R. Co. v. Alsbrook, 146
U. S., 279, 293.

In those cases the defendants claimed that the Constitution was not violated, because no contract had been impaired. So here the defendant in error urges that no claim was made by anybody that the United States had power under the

Constitution to tax capital directly without apportionment. But, in order to obviate the necessity for such a claim, capital was held to be income, and the judgment of the trial court resulted in the imposition of a direct tax on capital, without apportionment, just as in the two cases last cited the constitutional question was attempted to be evaded by the contention that the contracts had no existence.

It is not necessary for the lower court specifically to decide the constitutional question, if its judgment results in rejecting the claim of constitutional violation.

Chapman v. Goodnow, 123 U. S., 540, 548;
Chicago Life Ins. Co. v. Needles, 113
 U. S., 574, 579.

The case still involves a constitutional question, even though general principles of law are involved.

In *Osborn v. Bank*, 9 Wheat., 738, 820, the court said (Marshall, C.J.):

"There is scarcely any case, every part of which depends on the constitution, laws, or treaties of the United States. The questions whether the fact alleged as the foundation of the action be real or fictitious; whether the conduct of the plaintiff has been such as to entitle him to maintain his action; whether his right is barred; whether he has received satisfaction, or has in any manner released

his claims, are questions, some or all of which may occur in almost every case; and if their existence be sufficient to arrest the jurisdiction of a court, words which seem intended to be as extensive as the constitution, laws, and treaties of the Union, which seem designed to give the courts of the government the construction of all its acts, so far as they affect the rights of individuals, would be reduced to almost nothing."

In *Bridge Proprietors v. Hoboken Company*, 1 Wall., 116, 143, the court said:

"But the true and rational rule is, that the court must be able to see clearly, from the whole record, that a certain provision of the Constitution or act of Congress was relied on by the party who brings the writ of error, and that the right thus claimed by him was denied."

In *Fayerweather v. Ritch*, 195 U. S., 276, 299, the plaintiffs brought suit in the lower Federal court, contending that in a suit in the state court between substantially the same parties, the latter court had declined to decide whether or not certain releases executed by them were violated, and that the judgment of the state court, entered without so finding, resulted in depriving them of their property without due process of law. This court held that it had jurisdiction of a direct appeal from the Circuit Court, saying:

"The contention is not that the state courts erred in their finding in respect to this fact, but that there never was any finding. Such decision of the state courts, made without any finding of the fundamental fact, was accepted in the Circuit Court of the United States as a conclusive determination of the fact. Although these plaintiffs were parties to the proceedings in the state courts and presented their claim of right, if it be true that the necessary result of the course of procedure in those courts was a denial of their rights—a taking away and depriving them of their property without any judicial determination of the fact upon which alone such deprivation could be justified—a case is presented coming directly within the decision in 166 U. S., *supra* [*Chicago, Burlington, &c., Railroad Company v. Chicago*, 166 U. S., 226]. Giving effect in the Circuit Court to the state judgment does not change the character of the question. It is simply adding the force of a new determination to one wrongfully obtained, and adding it upon no new facts. Whether the contention of the plaintiffs in respect to the character of the state proceedings can be sustained or not is a question upon the merits and does not determine the matter of jurisdiction. That depends upon whether there is presented a *bona fide* and reasonable question of the wrongful charac-

ter of the proceedings in the state courts and the necessary result therefrom. We are of opinion that the jurisdiction of this court must be sustained."

And again, in *Penn Mutual Life Ins. Co. v. Austin*, 168 U. S., 685, 695, the court sustained a direct appeal from the Circuit Court, saying that it was not necessary that the constitutional claim be meritorious, but that "of course, the claim must be real and colorable, not fictitious and fraudulent."

In his able brief, the learned Solicitor General discusses four cases in support of his contention that no constitutional question is involved in this case, and refers to them as "the more significant" of the cases on the subject. In the first of these cases (*Arbuckle v. Blackburn*, 191 U. S., 405), the Arbuckles filed a bill in the Circuit Court of the United States to restrain the Dairy and Food Commissioner of Ohio from taking certain action under the Ohio Pure Food Law. The lower court denied the injunction on the ground that a court of equity had no jurisdiction to enjoin criminal prosecutions, and must not "draw to itself the administration of the criminal law of a state" (113 Fed., 616). The Food Commissioner had ruled that one of the Arbuckle products, known as "Ariosa," was adulterated within the meaning of the statute, and the Arbuckles contended that if the statute was held to apply to such a product

as theirs, it was not a proper exercise of the police power, and, therefore, contravened the Constitution of the United States. The disposition which the lower Federal court made of the case was such as to render the decision of the constitutional question unnecessary, and was that the plaintiffs had mistaken their remedy; that if the Food Commissioner's conclusions were erroneous and prosecutions were attempted, these could be successfully defended.

"Indeed," said Chief Justice Fuller, "in the only case called to our attention by counsel involving the status of Ariosa the Court of Common Pleas of Lucas County, Ohio, held that it was not within the prohibition of the statute" (p. 415).

As the lower court's decision was based on general principles of equity, and not on a construction of the Federal Constitution, this court dismissed the appeal for lack of jurisdiction. Had the lower court denied the injunction on the ground that Ariosa was within the terms of the statute, and that the statute as applied to Ariosa was a valid exercise of the police power, and therefore, not in conflict with the Constitution, there would have been some resemblance to the case at bar.

In the second case, *Cosmopolitan Mining Company v. Walsh*, 193 U. S., 460, 472, the Mining Company claimed that service of process made in other actions on its statutory agent in Colorado

was void. It was not disputed that the Mining Company had appointed the agent, and there was no evidence that there had been direct revocation of such agency, but the Company claimed that the agency had ceased because it was no longer doing business in Colorado at the time the service was made. The question decided was whether or not under the State statute the agency had terminated at the time service was made. It was perfectly patent that the statute was constitutional, whichever way it was construed, but the Company claimed that the courts had erroneously construed it, and that, therefore, as no valid service had been made, the courts were giving effect to an invalid judgment in contravention to the Federal Constitution. This court dismissed the writ of error, and the present Chief Justice said:

“The claim asserted under the Constitution of the United States was, therefore, merely conjectural and amounted to this only, that if under the law of Colorado or under the general law the service on the alleged agent was void, that it would be a violation of the Constitution of the United States to give effect to judgments based on such service. Not only the statement we have made from the record, but the argument at bar, makes this a demonstration. Thus, in the discussion at bar, it was stated that it was not claimed that the State of Colorado could not without a violation of the Constitution of the United

States have exacted that the authority conferred by a foreign corporation upon an agent to receive service of process should continue for the purpose of the enforcement of obligations contracted by the corporation, although the corporation had ceased to do business within the State, but that as the Colorado law when properly construed did not so provide, therefore the service was invalid, and the sale of the property of the mining company based on such service was void. This, however, as we have already shown, amounts but to the concession that the substantial controversy which the case presented involved the mere determination of what was the law of Colorado on the subject."

In that case there was no claim, as there is here, that the statute as construed conflicted with the Constitution; but the claim was that the statute ought to have been construed differently, and that because the court had erred in its construction of the statute, therefore, the Mining Company's rights under the Constitution were violated.

In *Sloan v. United States*, 193 U. S., 614, 621, a direct appeal from the Circuit Court of the United States for the District of Nebraska, upon the ground that the construction of a treaty was drawn in question, was dismissed for lack of jurisdiction. The complainants brought suit under the Act of Congress of August 7, 1882, to obtain

allotments of certain Indian lands. The trial court held that this statute had taken the place of all previous Acts and treaties and that the rights of the plaintiffs were to be determined by its terms. The previous treaties were referred to "only as an argument upon the issue directly in question, viz., the construction of the statute," and this court said:

"It cannot be said that the construction of any treaty is drawn in question herein when the rights of neither party are necessarily dependent upon such construction, but are dependent upon that which may be given the statute of 1882, and when the construction of that statute is independent of that which may be given any of the treaties mentioned, although weight may be given to the treaties in determining the question of the construction of the statute."

Had it been claimed there that the statute of 1882 as construed by the court violated the previous treaties, as it is claimed here that the statute of 1913 as construed by the District Court contravened the Constitution, the appeal would not have been dismissed.

American Sugar Refining Company v. U. S., 211 U. S., 155, 161, is the last of the "more significant" cases cited by the Solicitor General. There an application for certiorari was denied, and the Sugar Company then took a direct appeal to this court on the ground that the construction

or application of the Constitution of the United States was involved. It was claimed that the Secretary of the Treasury, in making regulations under the tariff laws, had gone so far that his action amounted to the exercise of legislative power. It was not contended that, as in the case at bar, the Act as construed by him violated the Constitution; but that he had misconstrued the Act, and that his action, therefore, was not authorized by the Act, and was unconstitutional because it constituted the exercise of legislative power. Neither the constitutionality of a law, nor the construction of the Constitution, was involved, but only the question what powers were conferred on the Secretary of the Treasury by the Act. A portion of the court's opinion is as follows:

"The admitted duty of the Secretary of the Treasury was to construe as best he could the paragraph relating to collection of duty upon sugars, and to promulgate regulations for carrying it into effect. Rev. Stat., §251. This and this alone he did. The only real substantial point involved is whether or not he misconstrued the statute, and that gives this court no jurisdiction upon direct appeal [citing cases].

"Undoubtedly Congress, without violating any constitutional provision, could have in terms directed exactly what was prescribed by the Treasury regulations; and prior deci-

sions have held that the statute was properly construed by the Secretary."

In conclusion, attention is called to the fact that if a motion to dismiss this writ of error is granted at this late date, then no appeal can now be taken to the Circuit Court of Appeals.

Darnell v. R. Co., 206 Fed., 445 (C. C. A.).

The Plaintiff would, therefore, have lost the right to have not only the constitutional questions, but the construction of the statute, reviewed. It is respectfully submitted that the motion to dismiss should be denied.

GORDON M. BUCK,
Counsel for Plaintiff in Error.

Supreme Court of the United States,

OCTOBER TERM, 1917.

SOUTHERN PACIFIC COMPANY,
Plaintiff in Error,

v.

JOHN Z. LOWE, JR., United States
Collector of Internal Revenue
for the Second District of New
York.

No. 452.

MOTION TO ADVANCE.

**In error to the District Court of the
United States for the Southern Dis-
trict of New York.**

The Southern Pacific Company, the plaintiff in error (hereinafter called the "Plaintiff"), seeks to recover a tax paid by it, under protest. This tax the defendant in error claimed the right to collect under the Income Tax Act of 1913 (38 Stat., L. 166).

In the latter part of the year 1913 the Central Pacific Railway Company, one of the Plaintiff's subsidiary corporations, decided to distribute its surplus. This entire surplus had been accumulated prior to July 1, 1909. The Plaintiff has owned all of the capital stock, and has also operated

under lease the railroads and appurtenant properties, of the Railway Company since the latter's incorporation in the year 1899. The Railway Company maintains no bank account, but the Plaintiff acts as its banker. Therefore, the entire properties of the Railway Company, including the surplus in question, have been in the custody and control of the Plaintiff ever since the accumulation of the surplus. In the first six months of the year, 1914, a constructive distribution of the surplus was made by the payment of several large dividends aggregating more than \$18,000,000. As the surplus from which these dividends were paid was already in the Plaintiff's possession, their payment was effected merely by book entries. A tax was assessed upon the dividends by the Treasury officials, who claimed that the constructive payment of the dividends in the year, 1914, made them income of the Plaintiff in that year, although the surplus thus distributed had been accumulated years before the adoption of the Sixteenth Amendment, and had been in the possession of the Plaintiff since its accumulation. A fuller statement of the facts will be found in the brief submitted by the Plaintiff in opposition to the motion to dismiss for want of jurisdiction.

The Plaintiff, by its counsel, now moves this Court to advance this cause upon the docket, and to set it down for argument upon such day during the present term as may be convenient to the Court, for the following reasons:

The case of *Towne v. Eisner, Collector*, No. 563 on the present docket of this Court, has been advanced, and it is expected to be heard in the week beginning December 10, 1917. That case involves the validity of a tax levied under the same statute upon a stock dividend paid in the latter part of the year 1913. The surplus capitalized by this stock dividend had been accumulated prior to January 1, 1913, and Towne, a stockholder, was assessed with a surtax on his pro rata share of the dividend. Therefore, that case involves two questions raised in the instant case, namely: (1) whether such a tax can constitutionally be imposed on a dividend paid from a surplus accrued prior to the Sixteenth Amendment, and (2) whether the statute should be construed to impose such a tax. While the foregoing questions of law are involved, the brief of counsel for the plaintiff in error in that case is chiefly concerned with the proposition that a stock dividend is not a distribution of income, and therefore does not constitute income of the recipient stockholder. Hence, it is of importance to the Plaintiff in the case at bar to be heard before the *Towne* case is decided.

Notice of this motion has been served upon the Attorney-General, and proof thereof filed with the Clerk of this Court.

Dated, December 5, 1917.

GORDON M. BUCK,
Counsel for Plaintiff in Error.



INCOME AND CORPORATION EXCISE TAX CASES.

Nos. 452, 705, 492, 422, 421, 594, 334, 593, 327.

EXTRACTS FROM REGULATIONS AND RULINGS OF COMMISSIONER OF INTERNAL REVENUE UNDER THE ACT OF AUGUST 5, 1909 (CORPORATION EXCISE TAX LAW) AND THE ACT OF OCTOBER 3, 1913 (INCOME TAX LAW).

Regulations No. 31, issued December 3, 1909, governing the administration of the Act of August 5, 1909, contain the following:

Article 2. Gross Income, subdivision 5:

"*Sale of capital assets.* In ascertaining income derived from the sale of capital assets, if the assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item of gross income to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price. If the capital assets were acquired prior to January 1, 1909, the amount of increment or depreciation representing the difference between the selling and buying price is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909, and which proportion shall be deducted from or added to the gross income for the year in which the sale was made. But for

the purpose of determining the selling price, as provided in this section, there shall be added to the price actually realized on sale any amount which has already been set aside and deducted from gross income by way of depreciation as defined in article 4 and has not been paid out in making good such depreciation on the property sold."

Treasury Decision 1675, dated February 14, 1911, being synopsis of decisions under Act of August 5, 1909, contains the following:

"55. Lands bought previous to January 1, 1909, and sold during the year 1910, should have the profits arising from such sale prorated in accordance with the number of years the land was held by the corporation and the number of years the law was in effect, if no accounting of increased value of land was made in returns for previous years."

Form 1040, prescribed as the original form for individual return of income under the Act of October 3, 1913, contained among the instructions endorsed on page 4 the following:

"13. Persons receiving fees or emoluments for professional or other services, as in the case of physicians or lawyers, should include all actual receipts for services rendered in the year for which return is made, together with all unpaid accounts, charges for services, or contingent income due for that year, if good and collectible."

Regulations No. 33, issued January 5, 1914, governing the administration of the Act of October 3, 1913, contain the following:

" Art. 109. In ascertaining net income derived from the sale of capital assets, if such assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price. If the capital assets were acquired prior to January 1, 1909, the amount of profit or loss representing the difference between the selling and buying price is to be prorated to determine the proportion of the gain or loss arising subsequent to January 1, 1909, and the proportionate part belonging to the years subsequent to January 1, 1909, shall be added to or deducted from the gross income for the year in which the sale was made."

" Art. 128. All losses claimed arising from sale of capital assets should be arrived at in the manner prescribed in Article 109, defining gains arising from sale of capital assets."

Treasury Decision 2090, dated December 14, 1914, being a synopsis of rulings under the Act of October 3, 1913, contains the following:

"*Profit from sale of real estate.* Profit is the difference between the selling price and the cost where the selling price is more than the cost.

'Cost of property purchased prior to the incidence of the special excise tax (Jan. 1, 1909), or the incidence of the income tax (Mar. 1, 1913), will be the actual price paid for the property, including the expense incident to the procurement of the property in the first instance and its sale thereafter, together with carrying charges of interest actually paid, insurance, and taxes actually paid prior to the incidence (special assessments, if any, 'actually paid' as 'local benefits' in connection with real estate); provided that where, up to the incidence of the tax, the expense of carrying property has exceeded the income from it, the difference between the expense of carrying and the income from the property shall be added to the purchase price, and the sum thus ascertained shall be the cost of the property; and provided further, that in the case of property purchased prior to the incidence of the tax and sale thereof subsequent to the incidence of the tax, there shall be excluded from consideration in ascertaining cost of any items of income, expense, interest and taxes previously taken into account in preparing a return of annual net income.

'The cost of property acquired subsequent to the incidence of the tax will be the actual price paid for it, together with the expense incident to the procurement of the property in the first instance, and its sale thereafter, and the cost of improvement or betterment, if any'.

The entire profits realized by individuals or corporations from the sale of real estate will be taxable except

where the property in connection with which the profit is obtained was acquired prior to March 1, 1913, in the case of individuals or prior to January 1, 1909, in the case of corporations; and then and in such event the profit will be prorated over the whole time the property was held, and that part of the whole profit apportioned to the taxable period will be reported in annual returns of income. In prorating, fractional parts of years will not be considered.

"For income-tax purposes, where there is an actual sale and transfer, profit will be considered as realized even though payment is to be made in installments, as notes for deferred payments are secured by the title to the property and presumably bear interest and are held to be worth, in cash, their face value."

Treasury Decision 2291, dated January 29, 1916, contains the following :

"The provision in T. D. 2005, viz, 'In prorating, fractional parts of years will not be considered', is hereby amended to read as follows :

'In prorating, the actual time property has been held will be ascertained in months, a fractional part of a month in the actual time being counted as a whole month when the fraction is 15 days or more and discarded when the fraction is less than 15 days'.

For the purpose of ascertaining the amount of gain or loss to be shown in returns of income, arising in connection with property which was acquired prior to March 1, 1913, in the case of individuals or prior to

January 1, 1909, in the case of corporations, the total gain or loss will be ascertained as provided by the rule set forth in T. D. 2005. This total gain or loss will be divided by the actual time (ascertained as herein set forth) the property was held, and the quotient will be multiplied by the time in months subsequent to March 1, 1913, in the case of individuals, and subsequent to January 1, 1909, in the case of corporations. The fractional part of a month within the tax period will be treated as a whole month when the fraction is 15 days or more and discarded when the fraction is less than 15 days."

Compiled by
HENRY W. CLARK,
Counsel for plaintiff-in-error in No. 705.

INCOME TAX QUESTIONS

WHAT IS INCOME?

Outline

1. Taking our first viewpoint at the time of the commencement of the first period under the first act, the date substantially of the Constitutional amendment, we have from the first felt that no subsequent change in the form of any then existing property or right to property could possibly fall within the Constitutional "power to lay and collect taxes on incomes" without apportionment among the States. That is, the conversion of property or of a right to property in the *form of income received*, in cash or its equivalent, did not, and could not, make "income" within the meaning of the constitutional amendment or of any statutory levy of "*income*" under that amendment.

We cannot at this time prepare a full discussion of the authorities and considerations on which this view is based. No word or clause was ever inserted in any Constitutional amendment as to which the legislative and popular sense in which it was used was so well known and recognized as was the legislative and popular interpretation and intent of the word "incomes" (*plural*) in the XVIth Amendment.

The most widely recognized authorities agree with the popular conception of an income tax (and of "incomes" under an income tax) that it rests on the principle of "*ability to pay*" out of income and aims to reach what Dr. Seligman has called

"that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it his capital remains unimpaired."

That this was the legislative and popular view on which the Income Tax Amendment to the Constitution was proposed and adopted, is so well known as hardly to justify citations.

That the Amendment would not have been proposed or adopted on any other view is equally plain.

That it was intended to give Congress power to tax as such the proceeds of the sale of one's house, the gross receipts of one's business, or any other factor of "in-come" (as distinguished from "out-go") is, in brief, preposterous.

The result of this viewpoint expressed so to speak in the terms of the Brushaber decision is that a tax on gross receipts or on factors of income, or on capital in the form of "in-come" as distinguished from "out-go," is in effect a direct tax on the capital subject to the rule of apportionment and not taken out of that rule by the XVIth amendment. This, because such a tax is not a tax "on incomes" in the plain sense authorized by the amendment. It is in a very real sense a direct tax under the Pollock case.

Congress in the enactment of the law and the Treasury in its original administration recognized this principle. Gradually, however, by oversight and in some instances by design, we have in some of the details of the statutes and even more in the administration and now in the attitude of the Government toward the tax, developed the idea of taxing gross income, factors of income, capital in the form of "in-come" and somewhat lost sight of the principle and purpose which was all recognized as the sole principle and purpose of the constitutional amendment and originally of the statute.

Though the Courts have repeatedly upheld excise taxes measured by gross income and factors of income, these decisions have no bearing on the income tax cases now pending, which, because of the omission to apportion the tax,

rest for their authority upon the XVIth Amendment. They also do not affect the excise income tax cases now pending in so far as the question involved is as to the primary meaning and application of "income" as used in the statute.

The 1913 act was on the *so-called accrual* basis, which broadly applied tended to allocate net income in its proper sense to the period when it arose or accrued, i. e., its benefit became available to or at the disposal of the *recipient* of such *benefit*. For reasons deemed satisfactory the 1916 act met the main problem in a more direct and fundamental way. It levied the tax primarily on "*income received*," but at the same time and as though to make plain the purpose to reach and tax only "*incomes*" in the Constitutional sense, it added in sub-division (g) of Section 8 the important provision providing that

"an individual keeping accounts on any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect HIS INCOME, may, subject to the regulations,"

make his return and have his tax computed on this basis.

This simple provision is in a sense a key to the past and present income tax acts and, in fact, to the XVIth Amendment. It discloses almost unconsciously the purpose and intent of the amendment and of the act. "Income" in this illuminating sub-division of Section 8 does not mean "gross income." It means "net income" or "taxable income," an "income" which has its plural "incomes," an income "which is at the disposal of the owner for purposes of consumption, so that in consuming it his capital remains unimpaired." No "exercise in dialectics," however ably carried on, can, we believe, alter this necessary interpretation in this "key" provision of the act. It is, we feel sure, what was originally meant

by the Congress and by the people or State legislatures in proposing and adopting the income tax amendment. It is what was and is always meant by "income" or "incomes" as an object or objects of a revenue tax.

"Income" in its popular and true sense as a subject of revenue taxation is the "taxable income" authorized to be taxed by the Constitution and sought to be taxed by statute. It is the equivalent of "profits or gains" under the English act and of "profits" as construed in the Little Miami case (108 U. S. 277), except that the latter may apply to a business or transaction, but "incomes" are "incomes" only of the person. A factor of income may be spoken of as "income." *But two factors of income are never "incomes."*

"Income as used in our (South Australia) act is used in two senses, the gross 'income' and the 'net' or 'taxable income,' and in the latter sense is equivalent to 'profits and gains' in the English act, which are ascertained after expenses are deducted from receipts."

Australian Soc. v. Commrs. (1907) S. A. Law. Rep. 93.

In the view above outlined we excluded in the first instance as not open to question—

(1) A capital asset converted into cash or other equivalent at not exceeding a provable value antedating March 1, 1913.

(2) A sales asset converted into cash or other equivalent at not exceeding such an antecedent provable value.

(3) A right accrued on March 1, 1913, reduced to possession thereafter, to recover.

(a) A salary or wage for services previously rendered.

(b) A professional fee for prior services.

(c) A sum due on a contract, including a profit, for work or materials previously furnished.

- (d) A dividend on stock previously declared.
- (e) Interest matured on bonds or debentures.

In taking this view, we applied what we considered the only possible construction to the word "income" in a tax statute, that is the beneficial business sense which (from the viewpoint of time) meant a future net *earning* or net *profit* of the taxpayer to be secured from future services or labor or investment or to accrue in the future from existing investments. No property or right in property then existing could by being changed in form or reduced to possession constitute income subject to a tax speaking *in futuro*. And we were and are *inclined* from this viewpoint to further exclude

(4) A right to a share in the profits of a corporation earned prior to March 1, 1913, later reduced to possession by the declaration and payment of a dividend.

(5) A right to interest then accrued on a bond though not collectible until the maturity of the coupon or interest date.

We are inclined to accept today the principle in this respect of *Collector v. Hubbard*, in 12 Wallace.

None of these things, as we view it, should constitute *future income* from the viewpoint of any given date.. An ordinary periodical dividend or interest payment from a casual viewpoint might be considered as income of the individual *when received*—no serious question would be raised—yet this view would not apply nor be acceptable to an interest payment on a two years' note, maturing the next day nor to a dividend representing an earning accumulated over a preceding two-year period. In each case it is quite possible that the person who receives the interest or dividend had bought the note with accrued

interest or the stock with the right to share in the accrued earnings on February 28, 1913, paying for the accrued interest *eo nomine* and for the right to share in the accrued earnings though not *eo nomine*. In each case the interest or dividend would certainly be capital to the vendee, and the income realized by the vendor was received February 28, 1913.

2. Incidentally—if this is its logical place—we have to consider “income,” from the viewpoint of the person buying today the stock with accrued earnings or the bond with accrued interest. In neither case *nor at any time* can the *past* accrual in which he has invested his principal be “income” to him. Its “income” has been realized by the vendor who has sold to him the right accrued during his ownership. If A bought certain stock for \$10,000 in 1913 and sold it to B for \$50,000 in March, 1917, and the company on April 1st paid B \$40,000 as a cash dividend, A would be taxable for the period of 1913 to March, 1917, on the “income” reduced to cash in the sale to B. If B were also to be taxed, the tax would fall on the same “income” taxed against A and would deprive B not of his “income” but of his principal.

3. If at this point we look at the end of the first accounting period we meet the other side of the same questions in different form. Having in mind the “income” to be credited to the first period and bearing in mind the assumed continuity of the tax, we find a great deal of business carried over to the succeeding period. When we stop at the end of the year there are many items, including

- (a) Work or goods furnished during the year and paid for.
- (b) Work or goods furnished during the year and not yet paid for.
- (c) Work in course and uncompleted.
- (d) Goods on hand and unsold.

(e) Stocks and bonds with accrued earnings or increased values but not yet sold.

(f) Stocks and bonds depreciated in market value and unsold.

In considering these items from this viewpoint we have two general questions (1) what *may be* taxed as income and (2) what *has been* taxed as income of the accounting period.

In meeting the first question we are inclined to think that the broadest view is the sound view, that anything and everything in the way of gains and profits that enters into and makes a beneficial income capable of reduction to possession and enjoyment by the beneficiary *may be* included in determining taxable income, just as on the other hand we insist that *anything that plainly diminishes that income must be deducted before there is a taxable income*. The single test of *power* is that of a beneficial net income of the person, natural or (under the statute) artificial, which can be spent, reduced to possession or reinvested. The fact that the beneficiary does not elect to spend it, to reduce it to possession, to reinvest it, that he prefers to leave it as it is, invested as it is, possibly borrowing against its increase for his spending, does not deprive it of its fundamental and beneficial character.

I hold 100 shares of Chesapeake & Ohio Railroad stock bought at 45, now selling, we will suppose, at 55. To tell me that if I keep this stock I am not even permitted to treat as *income* the increased value, but that if I trade it for an equal amount of Baltimore & Ohio stock, selling, we will suppose, at 55, I necessarily have income in the increased value, is making a substance out of a form. To say that the Government cannot tax the increase in the value, though I can borrow against and spend it, though I can sell twenty shares for cash and

keep the other eight to represent my original principal, is to put it in the power of taxpayers to avoid the taxing power of the Government by obtaining their income in this way. *We are dealing now with the question of power*, and we are inclined to the view that under the constitutional power to tax income, nothing that has the beneficial substance of income can be entirely outside of that power.

One qualification—a very necessary qualification we make to the foregoing: The increase unless realized must be clearly provable and beneficial. It must not be, for instance, an increase in the appraised value of real estate unless it can in fact be sold at that value, and it must, with respect to any increase, be one that on approved business standards can be treated as “income” or profit for the purpose of use or distribution as such. It must also, we think, be an increase in property held for sale or investment not for use.

4. In meeting the second question of what has been taxed, we are inclined to exclude from income for a given period any item of income not reduced to some form of realized income or treated or reported by the taxpayer as income. The act provides a continuing tax and it is a question not of power but merely of the incidence of the tax, whether it falls in one or a later taxing period. We believe the Congress did not intend that the tax should fall upon income until received, or at least until by some affirmative act in a given period the taxpayer recognized or availed himself of it as income, i. e., takes the benefit of it, or voluntarily returns it as income for the period. Congress has not required him to return it, but when he does return it, it becomes taxable. It has, by sub-division (g) of Section 8, permitted him to return it.

Referring back to the items in question at the end of the taxable year we include as taxable items (a) and (b)

and exclude items (c), (d) and (e) unless the taxpayer himself recognizes and returns them as income.

And we deduct depreciation, item (f), from (a) and (b), because *whatever we say as to appreciation, item (e)*, where it exists, we know that any profit in (a) and (b) is not a real profit unless depreciation, item (f), is deducted. A corporation with the three items (a), (b) and (f) would impair its capital if it declared dividends in the amount of (a) plus (b) without deducting (f). We would not, however, quarrel with a common sense ruling requiring appreciation (e) to be offset against depreciation (f).

We do, therefore, exclude from the first taxable year property or rights previously existing and changed in form or reduced to possession during the taxable year, and also exclude similar property and rights not so changed or reduced at the end of such year, though arising in it, in the absence of an affirmative intent to tax them *within the given period*.

5. We now having facing us the future taxable periods and the necessity of allocating the taxable income to them. While the second year may carry simply a continuation of the tax of the first year, it may also carry (1) an increased tax or (2) *a new tax* on "income."

Without qualifying the proposition stated from the viewpoint of the commencement of the tax we recognize that the division into taxable periods is one of convenience. Every future accrual is an item of income, but the question of when it shall become taxable "income" within the *intent* of that term applied to a particular period is not affected by the fact that a past accrual is not within the intent at all.

In the case above supposed of the stock bought by A for \$10,000 and sold to B in March, 1917, for \$50,000, there is no question of the fact (waiving any question as to

taxing an increase in capital) that the \$40,000 was income to A during the period named. If it appeared that the market value of the stock was \$52,000 on December 31, 1916, all reflecting prior earnings of the corporation, and we had a new income tax in 1917 and a *new excess profits tax on income* in 1917 claimed to be applicable to A's \$40,000 profit, A would object very strenuously to any claim that his \$40,000 profit was income for 1917. In fact, the *new taxes* on income would deprive him of a large part of his supposed principal in 1916. This principal was subject to the pre-existing and continuing tax against the "income" accrued in it, the incidence of the tax merely awaiting conversion of the accrued profit into cash, but subject to this prior tax on accrued income it was on January 1, 1917, principal. It could not become in any beneficial sense income for 1917. But the Government might answer that he had not paid any tax on it in 1913 to 1916, to which he might reply that no tax was claimed for those years and that he would have been glad to pay it and would pay it now according to the tax rates levied for those three years.

Let us assume that there had been during those prior years a uniform single tax of five per cent on "income" payable yearly which in 1917 was supplemented by a new twenty per cent, and also by a new excess profits tax on "income" measured by the percentage of the income to the original cost of the investment from which it was realized, and that the sole question is as to the amount of A's tax on the \$40,000.

We have both

- (1) The constitutional question of the power to tax A in 1917 on his \$40,000 profit realized by the actual earnings of the company in 1913 to 1916, and
- (2) The statutory question of how the \$40,000 is to be

taxed under (a) the original 5% tax payable annually and (b) the 1917 increased tax and new tax.

We submit that the *new* 1917 tax, both the new income and the new excess profits tax, must be read as of the date, or at least the year, of its enactment and under the view first expressed the Congress cannot by a new tax in 1917 tax *as income* and *under the Constitutional amendment* a right to the earnings of 1913 to 1916 converted into cash by the sale of the stock in 1917.

Also, that it was not the intention of Congress to impose these new taxes on income accrued but not received prior to 1917.

Further that though not previously taxed, the profit realized by sale in 1917 would be subject to the previous tax at the rate of five per cent payable annually and should be paid at that rate.

Finally, if, as is of course the fact, the rate for each prior year was different, the profit attributable to each year must be apportioned on a correct business or legal method and taxed according to the rates of those years.

6. One more and very important consideration might be mentioned. Assuming that A was engaged in the business of a dealer in securities and that the net profit of such business in 1917, crediting the \$40,000 profit and deducting losses, was \$30,000, but that by a deal in real estate during the year outside of his regular business he lost \$30,000, we feel very strongly that he has no income which can be taxed for that year under the Constitutional amendment authorizing "taxes on incomes." *He has no income* at all. The \$40,000 profit is a factor of income as is the \$30,000 net profit from *his business*, but neither of these factors is *his income*, it seems to us, within the XVIth Amendment, or subject to a tax "*on incomes*."

Let us take another concrete case. M in 1917 had an

incorporated oil business which cost him \$500,000 in 1913 (in the shape of wells and development). In 1916 he was offered and refused \$3,000,000 for it. In 1917 the business earned \$400,000, after paying an excess profits tax of \$300,000 on the corporation. M sells the stock in December, 1917, for \$3,000,000, after receiving cash dividends of \$300,000 out of the year's profits.

It is quite possible in this and many such cases that the combination of excess profits and income taxes (all in fact income taxes as applied to the individual) as now administered will leave the individual with a mere fraction of what was on January 1, 1917, his capital, and yet each tax is declared to be, and popularly supposed to be—and we contend that in law should be—a tax on *income* for 1917. The result must shock the conscience not only of the public, but of any court which is called upon to construe the act and apply the constitutional test to its attempted construction.

Such results must, however, be expected with increasing confusion, as the taxes multiply. They can be avoided only by a clear enunciation of principle which, sustaining the laws, will subject their application in each case to the fundamental test of "income," as "that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired."

ROBERT R. REED,

*Of Counsel for Investment Bankers' Association
of America.*

INDEX.

	Page.
INTRODUCTION	3
STATEMENT	4
CLASSIFICATION OF CASES:	
Group I. Corporate dividends declared from surplus earnings accumulated prior to the beginning of the taxing year in question.....	4-5
<i>Southern Pacific Co. v. Lowe</i> , No. 452. <i>Peabody v. Eisner</i> , No. 705.	
Group II. Profits arising from the enhanced value of timber or ore land accrued prior to but realized and distributed during the taxing year in question; and deductions claimed for depletion of timber or ore lands.....	5-8
<i>Doyle v. Mitchell Brothers Co.</i> , No. 492. <i>Lynch v. Hornby</i> , No. 422. <i>Lynch v. Turrish</i> , No. 421. <i>United States v. Bivabik Mining Co.</i> , No. 594. <i>The Goldfield Consolidated Mines Co. v. Scott</i> , No. 334.	
Group III. Profits realized by corporations upon resale of shares of stock in similar corporations purchased prior to but sold during the taxing year in question.....	9-10
<i>United States v. The Cleveland, Cincinnati, Chicago & St. Louis Railway Co.</i> , No. 593. <i>Hays v. The Gauley Mountain Coal Co.</i> , No. 327.	
ARGUMENT	10-90
I. The law applicable to all cases.....	10-72
A. The statutes.....	10-18
B. Definition of terms used.....	18-33
1. Capital and income distinguished.....	19
2. Capital defined.....	21
3. Income defined.....	23
4. Net income defined.....	23

II

	Page.
5. Capital value defined.....	25
6. Invested capital defined.....	27
7. Methods of account keeping are not decisive..	28
8. Summary.....	33
C. The propositions applicable to the present cases.....	34-72
1. Income being derived from the use of capital, the conversion or transfer of capital always produces income.....	35
2. Mere appreciation of capital value does not produce "income," nor mere depreciation "outgo".....	51
3. Net income is the difference between actual "income" and actual "outgo".....	61
4. Income is not confined to money income.....	71
II. The several cases at bar.....	73-90
Group I:	
<i>Southern Pacific Co. v. Lowe</i> , No. 452.....	73
<i>Peabody v. Eisner</i> , No. 705.....	79
Group II:	
<i>Doyle v. Mitchell Brothers Co.</i> , No. 492.....	79
<i>Lynch v. Hornby</i> , No. 422.....	82
<i>Lynch v. Turrish</i> , No. 421.....	83
<i>United States v. Bivabik Mining Co.</i> , No. 594.....	85
<i>The Goldfield Consolidated Mines Co. v. Scott</i> , No. 334.....	85
Group III:	
<i>United States v. The Cleveland, Cincinnati, Chicago & St. Louis Ry. Co.</i> , No. 593.....	86
<i>Hays v. The Gauley Mountain Coal Co.</i> , No. 327...	90
CONCLUSION.....	90
APPENDIX A (Corporation Tax Act of August 5, 1909, 36 Stat. 11, 112).....	93
APPENDIX B (Income Tax Act of October 3, 1913, 38 Stat. 114, 166).....	99

AUTHORITIES CITED.

CASES.

	Page.
<i>Alianza Co. v. Bell</i> (1906), A. C. 18.....	39
<i>Anderson v. Forty-Two Broadway</i> , 239 U. S. 60	11, 24
<i>Assets Co. v. Forbes</i> , 3 Tax Cas. 542.....	41
<i>Australian Society v. Commissioner of Taxes</i> (1907), S. A. Law Rep. 88.....	24
<i>Bailey v. Railroad Co.</i> , 106 U. S. 109.....	47
<i>Baldwin Locomotive Works v. McCach</i> , 215 Fed. 967.....	59
<i>Blake v. Imperial Brazilian Ry.</i> , 2 Tax Cas. 58.....	40
<i>Brushaber v. Union Pac. R. R. Co.</i> , 240 U. S. 1.....	75
<i>Bundy v. Nygaard</i> , 163 Wis. 307.....	45
<i>Burnley S. S. Co. v. Aiken</i> , 3 Tax Cas. 275.....	56
<i>Californian Copper Syndicate v. Harris</i> , 5 Tax Cas. 159 41, 72, 83	
<i>Central Bank v. United States</i> , 137 U. S. 355.....	77
<i>City of London Contract Corporation v. Styles</i> , 2 Tax Cas. 239.....	39
<i>Coltless Iron Co. v. Black</i> , 6 App. Cas. 315.....	39
<i>Commissioner of Taxes v. The Melbourne Trust Co.</i> (1914), A. C. 1001.....	44
<i>Commissioners of Taxation v. Antill</i> (1902), A. C. 422.....	56
<i>Commissioners of Taxation v. Kirk</i> (1900), A. C. 588.....	17, 55
<i>Corke v. Fry</i> , 3 Tax Cas. 335.....	72
<i>Davidson v. Commissioner of Taxes</i> (1917), A. C. 542 44, 57, 77	
<i>Delage v. Nugget Polish Co.</i> , 92 Law Times Rep. 682.....	39
<i>Dovey v. Cory</i> (1901), A. C. 477.....	65
<i>Edwards v. Keith</i> , 224 Fed. 585, 231 Fed. 110, 243 U. S. 638.....	59
<i>Eyster v. Centennial Board of Finance</i> , 94 U. S. 500.....	83
<i>Farrington v. Tennessee</i> , 95 U. S. 679.....	76
<i>Flint v. Stone-Tracy Co.</i> , 220 U. S. 107.....	11, 89
<i>Gibbons v. Mahon</i> , 136 U. S. 549.....	58, 74
<i>Gillatt v. Colquhoun</i> , 2 Tax Cas. 76.....	39
<i>Gould v. Gould</i> (No. 41, October Term, 1917).....	71
<i>Gray v. Darlington</i> , 15 Wall. 63.....	48, 57, 87
<i>Gray v. Hemenway</i> , 212 Mass. 239.....	79

	Page.
<i>Hudson's Bay Co. v. Stevens</i> , 25 Law Times Rep. 709, 5 Tax Cas. 424	42
<i>Humphreys v. McKissock</i> , 140 U. S. 304	74
<i>Illinois Central R. R. Co. v. Int. Com. Comm.</i> , 206 U. S. 441	63
<i>In the Matter of the Income Tax Acts</i> , 25 Vict. Law Rep. 679	45
<i>Income Tax Cases</i> , 148 Wis. 456	72
<i>John Foster & Sons v. Commissioners of Inland Revenue</i> (1894), 1 Q. B. 516	78
<i>Kansas City So. Ry. v. United States</i> , 231 U. S. 423. 22, 27, 63	
<i>Kauri Timber Co. v. Commissioner of Taxes</i> (1913), A. C. 771	44, 56, 80
<i>Klar Piquette Mining Co. v. Plattville</i> , 163 Wis. 215	85
<i>Knoxville v. Water Co.</i> , 212 U. S. 1	28, 63
<i>Last v. London Assurance Corp.</i> , 2 Tax Cas. 100	23
<i>Lewellyn v. Gulf Oil Corporation</i> , 245 Fed. 1	3
<i>Little Miami etc. R. R. Co. v. United States</i> , 108 U. S. 277	58
<i>London Cemetery Co. v. Barnes</i> (1917), 2 K. B. 496 ..	70
<i>London County Council v. Atty. General</i> (1901), A. C. 26	68
<i>Memphis etc. R. R. Co. v. United States</i> , 108 U. S. 228	76
<i>Merchants' Insurance Co. v. McCartney</i> , 12 Int. Rev. Rec. 122, 1 Low. 447	47
<i>Nisam's Guaranteed Ry. Co. v. Wyatt</i> , 2 Tax Cas. 584, 24 Q. B. Div. 548	40
<i>Northern Assurance Co. v. Russell</i> , 2 Tax Cas. 551 ..	40
<i>Nunemacher v. Widule</i> , 163 N. W. 644	46, 60
<i>Ounsworth v. Vickers Limited</i> (1915), 3 K. B. 267, 6 Tax Cas. 671	70
<i>Peterson v. Chicago, B. I. & Pac. Ry.</i> , 205 U. S. 364 ..	78
<i>Pfister v. Widule</i> , 163 N. W. 641	46, 60
<i>Pfister Land Co. v. City of Milwaukee</i> , 165 N. W. 23 ..	60
<i>Pretoria-Pietersburg Ry. Co. v. Elwood</i> , 6 Tax Cas. 508, 98 Law Times Rep. 741	40

	Page
<i>Railroad Co. v. Collector</i> , 100 U. S. 595.....	48
<i>Reg. v. Comm'rs of Southampton</i> , 4 Law Rep. H. L. 449.....	24
<i>Sallie F. Moon Co. v. Wis. Tax Comm'n</i> , 163 N. W. 639.....	16, 45
<i>Scoble v. Secretary of State</i> , 4 Tax Cas. 618, 1 K. B. 494, A. C. 299.....	30
<i>Scottish Investment Trust Co. v. Forbes</i> , 3 Tax Cas. 231.....	40
<i>Salomon v. Salomon, etc., Co.</i> (1897), A. C. 22.....	78
<i>Spooner v. Phillips</i> , 62 Conn. 62.....	58
<i>Stanton v. Baltic Mining Co.</i> , 240 U. S. 103.....	49, 75, 80
<i>Stratton's Independence, Limited, v. Howbert</i> , 231 U. S. 399.....	49, 59, 80
<i>Sun Insurance Office v. Clark</i> (1912), A. C. 443, 6 Tax Cas. 59.....	69
<i>Taxation Comm'rs v. Mooney</i> , (1907), A. C. 342.....	43
<i>Tebrau Rubber Syndicate v. Farmer</i> , 5 Tax Cas. 658..	42, 83
<i>Tennant v. Smith</i> (189), A. C. 150, 3 Tax Cas. 158..	72
<i>Towne v. Eisner</i> (No. 563, decided Jan. 7, 1918).....	79
<i>Union, etc. Trust Co. v. Taintor</i> , 85 Conn. 452.....	79
<i>Union Pac. R. R. Co. v. United States</i> , 99 U. S. 402..	63
<i>United States v. Emery, Bird, Thayer Realty Co.</i> , 237 U. S. 28.....	88
<i>United States v. Erie Ry. Co.</i> , 106 U. S. 327.....	48
<i>United States v. Kansas Pac. Ry. Co.</i> , 99 U. S. 455...	57
<i>United States v. Smith</i> , 12 Int. Rev. Rec. 135.....	47
<i>Vallambrosa Rubber Co. v. Farmer</i> , 5 Tax Cas. 529..	69
<i>Van Dyke v. Milwaukee</i> , 159 Wis. 460.....	45, 60
<i>Verner v. General Investment Trust</i> , 2 Ch. 239.....	62
<i>Von Baumbach v. Sargent Land Co.</i> , 242 U. S. 503. 8, 49, 59, 80	
<i>Wallaroo and Moonta Mining Co. v. Comm'r of Taxes</i> , (1907) S. A. Law Rep. 64; (1914) <i>ibid.</i> 207.....	44, 57
<i>Zonne v. Minneapolis Syndicate</i> , 220 U. S. 187.....	88

VI

MISCELLANEOUS.

	Page.
Buckley's Law of Companies, 652.....	63
Cook on Corporations, 7th ed., sec. 546, pp. 1610, 1611.....	76
Fisher, "Nature of Capital and Income," 51-53, 345.....	20, 21
Hadley on Economics, 5.....	20
Kennan, Income Taxation, 1.....	19, 20
Lindley's Law of Companies, Vol. I, 543, 601.....	02, 76
"Return of a Company's Capital to its Shareholders," 26 Law Quarterly Rev. 231.....	76
Seligman, Income Tax, 19.....	20

THE INCOME TAX CASES.

In the Supreme Court of the United States.

OCTOBER TERM, 1917.

SOUTHERN PACIFIC COMPANY, PLAINTIFF IN ERROR, v. JOHN Z. LOWE, JR., UNITED STATES COL- LECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF NEW YORK.	}	No. 452.
---	---	----------

***IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES
FOR THE SOUTHERN DISTRICT OF NEW YORK.***

Also eight other cases advanced for hearing with the
preceding case, viz:

CHARLES A. PEABODY, PLAINTIFF IN ERROR, v. MARK EISNER, COLLECTOR OF INTERNAL REVENUE.	}	No. 705.
EMANUEL J. DOYLE, COLLECTOR OF INTER- NAL REVENUE, PETITIONER, v. MITCHELL BROTHERS COMPANY.	}	No. 492.

E. J. LYNCH, COLLECTOR OF INTERNAL
REVENUE FOR THE DISTRICT OF MINNE-
SOTA, PETITIONER. } No. 422.

v.

H. C. HORNBY. }

E. J. LYNCH, COLLECTOR OF INTERNAL
REVENUE FOR THE DISTRICT OF MINNE-
SOTA, PETITIONER. } No. 421.

v.

HENRY TURRISH. }

THE UNITED STATES OF AMERICA, PETI-
TIONER, } No. 594.

v.

BIWABIK MINING COMPANY. }

THE GOLDFIELD CONSOLIDATED MINES
COMPANY } No. 334.

v.

JOSEPH J. SCOTT, AS COLLECTOR OF U. S.
INTERNAL REVENUE, FOURTH CALIFOR-
NIA DISTRICT (certified case). }

THE UNITED STATES OF AMERICA, PETI-
TIONER, } No. 593.

v.

THE CLEVELAND, CINCINNATI, CHICAGO &
ST. LOUIS RAILWAY CO. }

S. A. HAYS, COLLECTOR OF INTERNAL
REVENUE FOR THE DISTRICT OF WEST
VIRGINIA, PETITIONER, } No. 327.

v.

THE GAULEY MOUNTAIN COAL COMPANY. }

BRIEF ON BEHALF OF THE UNITED STATES.

INTRODUCTION.

These cases are styled "The Income Tax Cases" because they all involve as the basic matter for decision the question of the meaning of the term "income," and especially of the true distinction between the terms "capital" or "property" and "income." It is true that some of them arise under the Corporation Excise Tax Act of August 5, 1909, 36 Stat. 11, 112, c. 6, and some under the Income Tax Act of October 3, 1913, 38 Stat. 114, 166, c. 16; since, however, the cases of the former class raise no question of "doing business" by the corporations concerned, but merely the application of the *measure* of taxation by income as defined in the act, it is believed that the same principles must in this respect govern both classes of cases. (See *Doyle v. Mitchell Brothers Co.*, 235 Fed. 686, 690; *Lewellyn v. Gulf Oil Corporation*, 245 Fed. 1, 7.) It has therefore been thought best and most convenient for the court to treat all the cases in one brief, in the order of, *first*, a short statement of each case, *second*, a discussion of the general principles deemed generally decisive of all, and, *third*, an application of these principles to each particular case with a special discussion of any features peculiar thereto. In addition, the cases appear to fall naturally into three groups having certain common characteristics, and the statement will take them up in this way. This division is necessarily more or less empirical, as each case demands but an application to a particular state of facts of the general principles referred to.

STATEMENT.

GROUP I. Corporate dividends declared from surplus earnings accumulated prior to the beginning of the taxing year in question.

SOUTHERN PACIFIC CO. v. LOWE, No. 452.

The case is here on direct writ of error to the District Court for the Southern District of New York, which decided in favor of the United States. (238 Fed. 847.)

The Southern Pacific Company owned, prior to January 1, 1913, all the capital stock of the Central Pacific Railway Company and of the Reward Oil Company. During the calendar year 1914 the Central Pacific and the Reward Oil Company declared and paid to the Southern Pacific Company extraordinary dividends out of surplus and undivided profits accumulated prior to January 1, 1913. The Central Pacific also paid a regular dividend to the Southern Pacific Company, part of which, it is claimed, came from surplus and undivided profits accumulated prior to January 1, 1913 (R. a10). These payments by the Central Pacific were effected by charging the Southern Pacific with the amount and crediting it to the indebtedness due from the Central Pacific to the Southern Pacific (R. 36, 37). In addition, the Central Pacific Company owned certain land on Long Island which it had taken in satisfaction of a debt, and in the year 1914 sold the same and distributed the proceeds to its stockholder, the Southern Pacific, (R. a10; R. 151, Plaintiff's Exhibit C.)

The question is whether these dividends so received by the Southern Pacific Company are income for the year 1914 under the Income Tax Act of October 3, 1913.¹

PEABODY v. EISNER, No. 705.

This case is here on direct writ of error to the District Court for the Southern District of New York, which decided in favor of the United States (R. 10).

During the calendar year 1914 the Union Pacific Railroad Company declared and paid an extraordinary dividend in shares of the stock of the Baltimore & Ohio Railroad Company which it had accumulated as part of its surplus assets prior to March 1, 1913 (R. 8). It also paid a cash dividend, part of which it is claimed came from surplus accumulated prior to that time (R. 4, 5). Peabody received during 1914 his proportionate share, as a stockholder in the Union Pacific Railroad Company, of these dividends. The question is whether they were income to him for the year 1914, under the Income Tax Act of October 3, 1913.

GROUP II. Profits arising from the enhanced value of timber or ore land accrued prior to but realized and distributed during the taxing year in question; and deductions claimed for depletion of timber or ore lands.

DOYLE v. MITCHELL BROTHERS COMPANY, No. 492.

This case is here on certiorari to the Circuit Court of Appeals for the Sixth Circuit, which decided against the United States. (235 Fed. 686.)

¹ There was also a first count (R. a2-a9), but by agreement it is not to be considered on these proceedings. (R. a18).

The Mitchell Brothers Company in 1908 acquired certain timber lands and paid for them at a valuation of \$20 an acre, at which amount they have always been carried on the books of the company (R. 99; Finding VII). The company's business was not trading in timber lands, but the manufacture and sale of lumber (R. 102; Finding IX-d). It claims the right to deduct from the gross income received from such sale of lumber in each of the years 1909, 1910, 1911, and 1912, the estimated value as of December 31, 1908, of the timber owned by it and used in each of said years in its lumber operations. The Commissioner of Internal Revenue allowed a deduction of the cost of the timber, and the question, therefore, is whether the proceeds of sale of lumber which is supposed to arise from the difference between the cost and the estimated value of the timber on December 31, 1908, was income for the year it was received under the Corporation Excise Tax Act of August 5, 1909.

LYNCH v. HORNBY, No. 422.

This case is here on certiorari to the Circuit Court of Appeals for the Eighth Circuit, which decided against the United States. (236 Fed. 661.)

The case is precisely the same as *Doyle v. Mitchell Brothers Company*, except that it arises under the Income Tax Act. Hornby was a stockholder in a lumber company owning timber lands, and received as such a certain dividend in 1914 (R. 6, 8-11). The question is whether that portion of said dividend which is supposed to be derived from the timber

valued as of March 1, 1913, was income for 1914 under the Income Tax Act of October 3, 1913.

LYNCH v. TURRISH, No. 421.

This case is here on certiorari to the Circuit Court of Appeals for the Eighth Circuit, which decided against the United States. (236 Fed. 653.)

Turrish was a stockholder in the Payette Lumber and Manufacturing Company, which was organized to buy, hold, and sell timberlands. Its paid-up capital stock was \$1,500,000, a large part of which it had, prior to March 1, 1913, invested in timberlands. These lands, having prior to said date greatly appreciated in value over the cost, Payette Company in 1914 sold them, together with its other assets, to Boise-Payette Company for \$3,000,000 in cash and the assumption of liabilities. This sum it distributed to its stockholders, including Turrish, upon surrender of their certificates, though apparently the corporation was never formally dissolved (R. 6-9). The Commissioner of Internal Revenue assessed Turrish on the difference between what he paid for his stock and what he received on this distribution, and the question is whether this amount is income to him for the year 1914 under the Income Tax Act of October 3, 1913.

UNITED STATES v. BIWABIK MINING COMPANY, No. 594.

This case is here on certiorari to the Circuit Court of Appeals for the Sixth Circuit, which decided against the United States. (242 Fed. 9.)

The Mining Company on June 23, 1898, purchased for \$612,000 a leasehold estate in certain ore deposits in the Mesaba Range. The covenants of the lease were in all material respects the same as those construed by this court in *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503. The Mining Company estimated the value of its ore in place on January 1, 1909 (as a deposit *en bloc*), at a certain amount per unit ton, *exclusive of royalty*, and the question is whether that portion of the proceeds of operations received by it in 1910 which is supposed to be derived from this estimated value *en bloc* on January 1, 1909, is income for that year under the Corporation Excise Tax Act of August 5, 1909 (R. 18, 19). As stated, the Government admitted that the amount represented by royalties paid was not income or could be deducted (R. 18, par. 5).

THE GOLDFIELD CONSOLIDATED MINES COMPANY *v.* SCOTT,
No. 334.

This case is here on a certificate from the Circuit Court of Appeals for the Ninth Circuit.

Four questions are propounded. In brief, they present the question whether under the Corporation Excise Tax Act of August 5, 1909, the Mining Company can deduct from its gross income any amount whatever for depletion of its ore deposits, and more specifically whether it can deduct the original cost of said ore deposits incurred prior to the taxing years in question, and calculated in accordance with certain regulations issued by the Commissioner of Internal Revenue (R. 6).

GROUP III. Profits realized by corporations upon resale of shares of stock in similar corporations purchased prior to but sold during the taxing year in question.

UNITED STATES v. THE CLEVELAND, CINCINNATI, CHICAGO & ST. LOUIS RAILWAY COMPANY, No. 593.

This case is here on certiorari to the Circuit Court of Appeals for the Sixth Circuit, which decided against the United States. (242 Fed. 18.)

In January, 1900, the Railway Company purchased certain shares of the stock of the Chesapeake and Ohio Railway Company for \$981,427.92, and on January 28, 1909, sold them for \$1,795,719, a difference of \$814,291.08 (R. 12). There is nothing in the record as to the purpose for which the shares were acquired, but the Government claims that they must be taken to have been bought in the interest of the C. C. C. & St. L. Ry. Co., as a going concern, and not merely as an investment, especially in view of the fact that the Chesapeake and Ohio connects with the Big Four at Cincinnati. The stock on January 1, 1909, was worth very nearly what it sold for on January 28, and the question is whether under the Corporation Excise Tax Act the income of the company for the year 1909 from this transaction was the difference between the original cost and the selling price of the stock, or the difference between this latter sum and the value on January 1, 1909, or anything at all.

HAYS v. THE GAULEY MOUNTAIN COAL CO., 327.

This case is here on certiorari to the Circuit Court of Appeals for the Fourth Circuit, which decided against the United States. (230 Fed. 110.)

It is precisely like the one just stated. The Coal Company in December, 1902, purchased certain shares of stock of a colliery company, and on October 16, 1911, sold them at a considerable advance. As in the previous case, the Government claims that the purchase must be taken to have been for the advancement of the company's business as a coal company and not as an investment. The question is whether, under the Corporation Excise Tax Act, any, and, if so, what income was received by the company in 1911 from this transaction.

ARGUMENT.**I.****THE LAW APPLICABLE TO ALL CASES.****A.****The statutes.**

In attempting to determine the law governing the present cases, the first thing as a matter of course is to see what the acts themselves say on the subject.

1. The Corporation Excise Tax Act of August 5, 1909, 36 Stat. 11, 112, levied a tax "equivalent to" one per centum on the *entire net income* over and above five thousand dollars *received from all sources during the year*. This net income was to be ascertained by

deducting from the gross amount of the income received within the year from all sources (1) the ordinary expenses actually paid within the year out of income in the maintenance and operation of the business and properties, (2) all losses actually sustained within the year including a reasonable allowance for depreciation of property, if any, (3) interest actually paid within the year on bonded or other indebtedness, (4) taxes paid within the year. There was also a provision made for a return on the same basis.

It is apparent, therefore, that the starting point of this act was "the gross amount of the income" and that the term "net income" meant merely the amount reached by deducting from this gross amount certain statutory allowances. In *Flint v. Stone-Tracy Co.*, 220 U. S. 107, 147, this court said of the act:

The evident purpose is to secure a return of the entire income, with certain allowances and deductions which do not suggest a restriction to income derived from property actively engaged in the business.

In *Anderson v. Forty-Two Broadway*, 239 U. S. 69, 72, this court said of the same act, after stating the opinions of the lower courts:

With these views we can not agree. There was error, as it seems to us, in seeking a theoretically accurate definition of "net income," instead of adopting the meaning which is so clearly defined in the Act itself.

* * * And it is very clear, from a reading of § 38, that the phrase "entire net income" as used in its first paragraph, has no

other meaning than that which is particularly set forth in the second paragraph, which declares, in terms, how "such net income shall be ascertained."

It is therefore established that "net income" had only a statutory meaning under this act (it will be noted that the words "profits and gains" are not used), and it is equally clear that the act contains no definition of "gross amount of the income," but assumes that its meaning is known.

2. The Income Tax Act of October 3, 1913, 38 Stat. 166, levied a tax (Subsection A, Subdivision 1) upon *the "entire net income arising or accruing from all sources in the preceding calendar year"* to certain persons. It provided (Subsection A, Subdivision 2) for a graduated supertax upon excess incomes and required every person subject thereto to make a personal return of his total net income from all sources for the preceding year under rules and regulations to be prescribed by the Commissioner of Internal Revenue, and for the purpose of the additional tax *"the taxable income"* of any individual was declared to embrace *"the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations,"* where it appeared that such gains and profits had been fraudulently left undistributed. It further provided (Subsection B) that *"the net income of a taxable person"* should *include* *"gains, profits, and income derived"* from certain specific sources as well as *"income derived from any source whatever"* *"includ-*

ing the income from but not the value of property acquired by gift, bequest, devise, or descent."

It was further enacted (Subaection B) that "in computing net income" for the purpose of the normal tax there should be allowed as deductions (1) the necessary expenses actually paid in carrying on any business (not including living expenses), (2) all interest paid within the year on indebtedness, (3) taxes paid within the year, (4) losses actually sustained during the year, (5) debts actually ascertained to be worthless and charged off within the year, (6) a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the business, not to exceed in the case of mines 5 per centum of the gross value at the mine of the output for the year for which the computation is made; but there was to be no deduction for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance had been made, nor for any amount paid out for permanent improvements or betterments made to increase the value of the property. Provision was made (Subsection D) that the tax "shall be computed" upon the remainder of said "net income * * * accruing during each preceding calendar year," and that to this end a return should be made in such form as the Commissioner of Internal Revenue should prescribe setting forth specifically "*the gross amount of income from all separate sources and from the total thereof, deducting the aggregate items or expenses and allowance herein authorized.*" The provision as to the

tax on corporations does not, it is believed, differ in any respect material to the present discussion from those in the Corporation Tax Act. Attention may be called, however, to the fact that the expression "received" is retained in Subsection G (b) (instead of "arising or accruing"), and that the provision as to depreciation reads "including a reasonable allowance for depreciation by use, wear, and tear of property, if any; and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits," not to exceed the amount above stated.

It seems clear that we have here again a starting point of "gross amount of income" which is not defined, and a statutory "net income" which consists merely of this undefined "gross amount of income" less those items alone which the act permits to be brought into the adjusted account; and that therefore the decisions in *Flint v. Stone-Tracy Company* and *Anderson v. Forty-Two Broadway* are directly applicable. It is true that in the latter case stress was laid on the fact that the Corporation Tax Act was merely a levy on the doing of business by corporations measured by a statutory standard of income; but it is believed that this was done so that the opinion of the court should not be supposed to cover a case which was not before it. The *ratio decidendi* of this court in *Anderson v. Forty-Two Broadway* is just as applicable to the Income Tax Act of October 3, 1913, as it was to the Corporation Tax Act. In neither act did Congress assume "a theoretically accurate definition of 'net income'" as a

basis upon which the tax should be levied. It assumed a theoretical "gross amount of income" but fixed deductions itself. It left entirely open the meaning of the original charge in the account, but defined the adjusting items of credit in this account so as to make the question as to them one of interpretation of the words used in the act.

It is true that the Income Tax Act (differing in this respect from the Corporation Tax Act) used the words (Subsection B) "gains, profits," and provided that "net income shall *include*" them; and it is true that in interpreting the English Income Tax Acts the word "include" has been held in this connection to be definitive in itself and not merely explanatory. (The use of "gains, profits," in the act of October 3, 1913, undoubtedly was borrowed from the Civil War Income Tax Acts which in their turn followed the English acts). It may be argued, therefore, that the word "include" is to be taken as defining what Congress intended by the term "net income," and as making therefore the expression "gains, profits" the important factor, so that if an item in the income account can not be considered, according to business principles or practice, a "gain" or "profit" it need not be brought into adjustment.

This view, however, is not supported by the language of the act taken as a whole. The return required by the statute is based in the clearest language upon the gross amount of income from all sources less the statutory deductions; and the whole tenor of the act makes it impossible to suppose that

Congress assumed as the fundamental substructure of taxation an undefined "net income" which was to be what any business man, accountant, or court should think the just amount of profits or gains a particular person should be deemed to have made under all the circumstances of his special case.

At this point it should be noted that in the Corporation Tax Act the basis was "net income *received* from all sources," while in the Income Tax Act it was (so far as individuals, not corporations, were concerned) "entire net income *arising or accruing* from all sources." This has been supposed to constitute a difference in the two acts, and to make the latter not a tax upon the basis of "gross amount of income" (according to the ordinary meaning of this expression) less the statutory deductions, but a tax upon a "net income" which exists or does not exist according to the judgment of an expert accountant as to whether a particular item should be charged or credited to the year in question (and therefore be said to "arise or accrue" in that year), or whether it should be spread over several years (as really "arising or accruing" during all of them). For instance, in the case of the *Sallie F. Moon Co. v. Wisconsin Tax Commission*, 163 North Western Rep. 639, it appeared that the Moon Company had received dividends on stock owned by it in the Northwestern Lumber Company. These dividends were paid out of surplus owned by the Lumber Company prior to the passage of the Wisconsin Income Tax Act. The Supreme Court of Wisconsin, in holding that these dividends were

taxable, felt obliged to distinguish the decision of the Court of Appeals for the Eighth Circuit in *Lynch v. Turrish* (one of the cases at bar). It did so by emphasizing the difference between the Wisconsin Act which used the word "received" and the Federal Income Tax Act of October 3, 1913, which used the words "arising and accruing." The court said (p. 640):

Hence, following the plain language of the law, if the dividends were *derived* from stock and if they were *received* during the year 1911, they were taxable. Unlike the federal act there is no need to ascertain when the income *arose or accrued* in order to determine whether it is taxable. The fact that it was *received* during 1911 makes it taxable irrespective of when it *arose or accrued*. [Italics ours.]

It will be noticed that the court laid stress upon another word, namely, "derived," and seemed to think that this term, as applied to dividends on stock, was a synonym of "received." Yet it has been said by an English judge in an income tax case depending upon an act of similar purport that "derived" means the same thing as "arising or accruing."¹

At this point it is enough to say that the act of October 3, 1913, taken as a whole, does not indicate an intention on the part of Congress to abandon

¹ Lord Davey in *Commissioners of Taxation v. Kirk* (1900), A. C. 588, 592:

"Their lordships attach no special meaning to the word 'derived,' which they treat as synonymous with arising or accruing."

a basis of gross amount of income less certain statutory deductions for a basis of a theoretical "net income" made up of items of "accrued" or estimated income and outgo which may or may not conform to actual facts or to the terms of the statute.

B.

Definition of terms used.

It is axiomatic that in tax matters the duty of the court is merely to interpret and follow the language of the statute, without reference to the conceptions of economists and business men. The statute is the first and last test. Nevertheless, to interpret the language of the Corporation Excise Tax Act and of the Income Tax Act, using as they do terms like "income," "profits," "gains," "depreciation," "losses," "received," "arising or accruing," etc., whose meaning is assumed to be understood, it is essential that the court should have as a background the meaning, if any, which those terms have had among intelligent men or students of business affairs. A special reason for this court's so doing lies in the claimed restriction of the Federal Government to a tax on "income," as distinguished from "capital" (unless apportionment be resorted to), a restriction apparently requiring an accurate delimitation of "capital" from "income." Nor can there be any evil in approaching the construction of the acts themselves with an understanding of the general principles which should determine the meaning

of the terms used. A French writer quoted by Kennan in *Income Taxation*, page 1, says:

So long as writers use words which have no precise signification, which may be and are interpreted in a variety of ways, and which may convey different ideas to different minds, there will be uncertainty in their theories, or rather there will be vague, incomplete, and poorly coordinated theories; and then, as all practice is the application of theories, the practice resulting from them will be faulty.

1. Capital and income distinguished.

(a) That the distinction between "capital" and "income" is important and must be made is admitted by all. Apart from special considerations as to the power of the Federal Government to tax "capital" as distinguished from "income," the history of tax legislation and the practical working of taxing systems in this country show the importance of the distinction. In point of time, property taxes came first, and income taxes were resorted to because it was felt that property taxes were unsatisfactory and insufficient, and that income taxes more correctly recognized the true relation of the taxpayer to the Government in the production and distribution of wealth. Then, too, whatever may be said in regard to the power of the Federal Government, the field of property taxation has been occupied by the several States which rely so largely on it, that the entrance of the Federal Government into it might prejudicially disturb existing conditions, and should be approached with hesitation.

(b) The fundamental economic distinction between "capital" and "income" lies in the element of time. "Capital" represents a *static* condition of the thing or of the relation of a person to the thing *at a certain period of time*. "Income" represents a *changing* or *dynamic* condition of the thing itself, or of the relation of a person to the thing *during a period of time*. Thus far, it is believed, all are agreed. A number of definitions given by economists are quoted in Professor Fisher's comprehensive work on "The Nature of Capital and Income," Appendix to Chapter VII, pp. 345-356. Practically all of them recognize as fundamental the element of time, though many lay stress on the idea that "income" must be regular so as not to diminish "capital" itself. In addition, President Hadley in his work on Economics, page 5, has the following:

Capital is being constantly converted into income and income into capital. But capital, under all times and conditions, is measured as a quantity, while income is more properly measured as a rate. Capital is a static conception, independent of time; income a dynamic conception involving the time element.

Kennan (Income Taxation, pp. 1-6) emphasizes chiefly the distinction between "income" (which he thinks means "net income") and gross receipts, but clearly recognizes the importance of the element of time. Seligman (The Income Tax, p. 19) gives the following definition:

Strictly speaking, income as contrasted with capital denotes that amount of wealth which

flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired.

Fisher (Nature of Capital and Income, pp. 51, 52, 53) says:

We have therefore the following definitions: A *stock of wealth* existing at an *instant* of time is called *capital*. A *flow of services* through a *period* of time is called *income*. Thus, a dwelling house now existing is capital; the shelter it affords or the bringing in of a money rent is its income. The railways of the country are capital; their services of transportation or the dividends from the sale of that transportation are the income they yield.

Business men when asked how much property they have, how much they are worth, at once resort to an inventory of the things or rights they own, estimating their value as at a certain time. Inquiry as to income, however, evokes a résumé of transactions over a period of time. So in legislation. Acts taxing property provide for an appraisement as of a certain fixed time. (Even where an average is provided for it is but the summing up of a number of such periods.) Acts taxing income, however, always fix a period of time, from one day to another, over which the computation is to extend.

2. Capital defined.

What, then, is the correct definition of "capital," and can there be "income" without "capital" as its source? Undoubtedly many persons define "capital"

in a restricted sense as including only material things or rights therein. Even all material things are not always included, but only so-called permanent factors, such as roadbed, fixed plant, land, mines, etc. These definitions have their value in determining what shall be charged to "expense" and what to "capital account" as a matter of sound financial management. This court is familiar with them from its consideration of such cases as *Kansas City Southern Railway v. United States*, 231 U. S. 423, 444-447. Such limited definitions can not, however, be adopted for the purpose of a correct analysis of "capital" and "income." It can not be denied that the most ephemeral factors of production, the cost of which should certainly be charged to "expense," share in the production of income in the same manner and for the same reasons as do the permanent factors. As related to "income," therefore, they are certainly "capital." Nor does more careful consideration justify the restriction of "capital" to material things, in so far, at any rate, as its relation to "income" is concerned. The statement that a man's stock in trade is his brains, or that a singer's capital is his voice, is not merely metaphorical. Looking at the world of production and distribution broadly, no objection is perceived to treating personal qualities or the rights of ownership therein as "capital." We are thus able to get a comprehensive definition of "capital" as *either those objective things, including rights, persons, and per-*

sonal qualities, which are capable of ownership, or the rights of ownership in the things themselves, considered at a moment of time.

3. Income defined.

If this broad definition be adopted, it will appear that "*income*," in the same broad sense, is simply *the service, advantage, emolument brought in to the owner by the use of his "capital."* Idle "*capital*" produces no income. As merely static, in its bare condition of "*capital*," it furnishes no advantage to its owner. Its value lies merely in the fact that it is capable (or is deemed capable) of doing a service in the future, of producing an "*income*" thereafter. Therefore, all "*income*" arises out of the use of "*capital*"; it is "*derived*," it "*arises*" or "*accrues*" from "*capital*" as its source; and *there can be no "income" without the use of a corresponding "capital."*

4. Net income defined.

It is plain that "*capital*," in the very great majority of cases where it is used, causes disservices as well as services. There is "*outgo*" as well as "*income*." *The difference between the "income" and the "outgo" is the "net income," or "profits," "gains," "net earnings," "net receipts," etc.* The word "*income*" simpliciter is often used as meaning "*net income*," and the usage is defensible. Nevertheless, its true meaning seems to be merely what comes in, i. e., the services performed by capital, as distinguished from the disservices or outgo. In *Last v.*

London Assurance Corp., 2 Tax Cases 100, 128, 129, (10 App. Cas. 438), Lord Fitzgerald said:

We are bound to adopt the interpretation put on "profits" in the *Mersey Docks v. Lucas* that the expression means "the incoming of the concern after deducting the expenses of earning them."

In *Reg. v. Commissioners of Southampton*, 4 Law Rep. H. L. 449, 472, Bramwell, B., said:

"Income" is that which comes in; not that which comes in less an outgoing.

This difference of meaning in the term "income" is not of great practical importance in the present cases on account of the decision of this court in *Anderson v. Forty-Two Broadway*, 239 U. S. 69, 72. However, to anticipate, it may be said of the acts now under consideration what Way, C. J., said of the South Australian Income Tax Act in *Australian Society v. Commissioner of Taxes* (1907), S. A. Law Rep. 88, 93:

The word "income" in our act is used in two senses—the gross "income" and the "net" or "taxable income," and in the latter sense is equivalent to "profits or gains" in the English act, which are a certain after expenses are deducted from receipts.

Sometimes, however, as in certain of the opinions rendered below in the cases at bar, the unconscious assumption by the court that "income" necessarily means "net income" or rather "profits" leads to an attempt to establish an ideal basis of "profits" or "gains" as being that amount upon which alone the taxpayer should *justly* be taxed.

5. Capital value defined.

The "value of capital" or "*capital value*" is frequently used as synonymous with "capital" and that use has led to confusion. "*Capital value*" is the expression of the relation between "capital" and some common standard such as money. It does not indicate necessarily what "capital" will sell for in the market, because that depends on demand and supply which is only partially affected by "capital value." The plant of the United States Steel Company has a "capital value" though, it may be, no purchaser could be found for it. How then is "capital value" determined? Since the only value "capital" possesses lies in its capacity to produce "income," "capital value" is necessarily based on the amount of income which the capital will produce *in the future*, for it is in the future its services are desired and any estimates of its value are based upon what it will do in the future. The future "income" which is taken into consideration is future "*net income*" for, of course, in estimating "capital value" the costs which will be incurred must be considered as well as the revenues received. In estimating this future "net income" the past costs and receipts may be considered to some extent.

Past expenses and receipts, however, are not considered in and for themselves in estimating "capital value," but merely as one of the elements reflecting future costs and receipts. "Capital value," therefore, is an index to future "*net income*."

It is not and can not be, in the nature of things, any index to past "net income."

This principle that "capital value" depends upon the future net income of "capital" is of general application and applies to all forms of "capital" whether it be personal abilities, rights, such as good will, stock of goods, permanent plant, lands, or mines. A man's life is "worth" what he will probably earn in the future, taken in connection with the probable years of life figured by the mortality tables. A patent is worth what it will annually produce in connection with the life of the patent. Goods owned simply for immediate sale are worth what they will bring; i. e., their "capital value" approximates their market value, or price, because the "income" expected from them is simply their practically immediate selling price less the cost of sale. The permanent plant is worth what it will produce during its useful life plus what it will bring in the market at the end.

Whether the "capital" be the most permanent or the most ephemeral which can be conceived, its "capital value" nevertheless is nothing but the discount as of a certain period of time of its entire income for the future. The only difference is that if the article be held for immediate sale its "capital value" approximates its "market value," while if it be held for the income it will produce through a long period of time, its market value or price will be conceived of as something materially different from its "capital value," and its future "net income" will not tend to be confused with the amount of the

lump sum it will sell for at the present time. This tendency to approximate "capital value" with "market value" in the case of goods held for immediate sale shows itself also in the case of "capital" of any kind whose owner in fact expects his "income" to come from the sale of it rather than from the use of it, whether such sale be expected in the immediate future or not. In other words, there is a tendency to make the *animus* of the owner controlling and to consider the future income as the selling price or the periodical receipts, the "capital value" as approximating the selling price or widely different from it, according to the intention of the owner to hold the "capital" as an "investment" or for sale. Thus, real estate is said to be an "investment" to the investor, but "working capital" to the real estate speculator; and so as to stocks, bonds, farms, mines, etc.

6. Invested capital defined.

The expression "*invested capital*" or "*investment*" seems to mean the amount of money expended to acquire certain "*capital*." Thus, in *Kansas City Southern Ry. v. United States*, 231 U. S. 423, 444, 445, this court refers to

the property or capital accounts, designed to represent the investment of the stockholders, and to show the cost of the property as originally acquired, with subsequent additions and improvements.

Used in this sense "*invested capital*" is not the same as "*capital value*" or "*market value*." All

costs are, it is true, as a practical matter, incurred for the purpose and with the intention to produce "capital" which will return income in the future. Otherwise they would not be endured. But, clearly, the event may not, for many reasons, correspond to the expectation, and therefore the cost is not a true index of "capital value." It may be a factor of importance in certain businesses, but it is not determinative. Neither is it determinative of "market value," for that, as has been stated, depends on demand and supply which may or may not be affected by cost. Therefore, the cost of reproduction was discarded by this court as a test of "capital value" in *Knorrville v. Water Company*, 212 U. S. 1, 9, and it was intimated that the true basis was cost of reproduction less depreciation (which would produce approximately a plant having the same income-bearing capacity for the future as the one under consideration). (See also page 11 of the same opinion.)

7. Methods of account keeping are not decisive.

(a) All businesses which find it necessary to present an accurate picture of their condition and operations keep a *capital account* and an *income account*. It should be noted, however, for what purpose these accounts are kept, so that the exact extent of their usefulness may be judged. It is not for the purpose of showing actual "income" and "outgo" during a specified period, but to give a picture of the *general* financial condition of the business for the benefit of

the owners, of the creditors, of the money lenders, and of the general public. It aims to show "capital value" as well as past "net income," and (what is of especial importance for present purposes) it aims to show the "capital value" as unchanged or increased and the income as regular or standard wherever possible by considering as related to "capital" any receipts or payments out of the ordinary, in excess of an ideal standard "income" or "outgo," and including in the "income" account only ordinary standard receipts and payments. The question for present purposes is, however, whether this method is useful in determining the meaning of "capital" and "income" in income tax legislation, or whether it does not lead to confusion in practice by leaving every case at the mercy of opportunist considerations. According to what has been said above, "income" is the actual service rendered by capital *within a certain period and as an actual fact*, while "outgo" is the disservice rendered under the same conditions. The nature of the "capital," whether permanent or ephemeral, whether held as an investment or for sale, the nature of the income, whether large or small, whether sporadic or regular, can not affect the question whether there is or is not a service or disservice of "capital," for this is a question of fact arising in actual transactions. To hold otherwise is but to say that a person has a certain "income" because he ought to have it; to apply to the actual changing world of affairs in which "capital" is constantly being converted into "income" and "income" into

"capital" an ideal standard of intact "capital" and standardized "income." It is to represent as a photograph what is in reality a kaleidoscope. The usage can not be applied to income from personal abilities, nor indeed to income from ordinary business transactions, and it is, therefore, an unsafe guide in the construction of an income tax act.

(b) In making up a statement of business it is usual to take an annual inventory of "*stock*," that is of that portion of "capital" which is ordinarily held for sale. (The "permanent capital" will not be inventoried but will be carried on the books at cost less depreciation, that is, at its "capital value.") This inventory may be based on cost. In that event it will be a true determinative factor in determining "net income," since it represents actual "outgo." Thus the "net income" or "profits" from the sale of inventoried articles will be the gross proceeds of sale less the expenses of sale, less the cost. There can be no objection, then, to such inventories as showing "net income" except the difficulty arising from the provisions of most income tax acts confining the "income" and "outgo" to an annual period. The inventory, however, may be (and probably generally is) based on "market value." In this case it will show approximately "capital value," as has been explained above, i. e., the estimated discount of the *future* "net income." Such an inventory, therefore, while most useful as a picture of the *future* prospects of the business, throws no light whatsoever on its actual "net income."

The actual "net income" may, as explained above, reflect to some degree the future net income and thus influence the estimate of "capital value" but "capital value" (or in this case selling price) can never affect or reflect past "net income."

(c) It may be that the inventory taken at the end of the year (on the market value) will be greater or less than that taken at the beginning. This may occur from two causes: (a) Actual capital may have been added to or subtracted from the items; (b) the market value of the same articles may be greater or less at the end than at the beginning of the year. In the first case, (a), plainly the change has no material significance for "income." The cost of the new capital or the selling price of the old will take its place in the income accounts as expense or receipt and that will be the end of it. The inventory merely records this transaction in the capital account. In the second case, (b), the inventories (showing as they do "market, i. e. capital value") merely record that at the end of the year the prospect of future income from certain capital is either better or worse than it was at the beginning of the year. This may be because the article has really risen or sunk in its capacity to produce future "net income," or also because of the scarcity or plenty of sellers or buyers in the market. In either case, however, the gain or loss in the inventory does not, and can not, throw any light on the matter of gain or loss in actual "net income."

Where the difference is due to demand and supply (e. g. in the case of a panic on the stock exchange), clearly the "market value" is irrelevant as a test of net income. That a stock has fallen heavily under such circumstances has no tendency to show what dividends were actually received on it in the past. Where the difference in the market value is due to something in the article itself in relation to its environment which indicates that it probably will as a matter of fact produce more or less "income" in the future than it was estimated it would a year ago, there is a true loss or gain during the year in the income-producing capacity of the "capital" in question, and hence a gain or loss to its owner. Does that mean that there has been a gain or loss in his "income" or only in the "capital value" of his property?

It seems (unless we are to deal in refinements not having any real utility in practice) that his "income" for the past year can not be said to have been affected by the change. He is himself richer or poorer at the end of the year than he was at the beginning; but this only means that his *prospects* of "income" are better or worse, not that as a matter of fact he actually "received" or that there actually "accrued" to him during the past year any more or less "income." His "capital" in fact did not render him any actual service or disservice during the year, and the result of his merely holding it is that the prospect of future service from it is greater or less.

8. Summary.

The following definitions and principles are submitted therefore as those which should be adopted in construing the acts under consideration in the present cases:

1. Capital is anything, material or otherwise, capable of ownership, viewed in its static condition at a moment of time, or the rights of ownership therein.

2. Income is the service or return rendered by capital during a period of time.

3. Outgo is the disservice or expense caused by capital during a period of time.

4. Net income ("profits") is the difference between income and outgo.

5. Capital value is the discount of all the income which it is estimated capital will produce in the future.

6. Investment or invested capital is the net cost of certain capital in the past.

7. In the actual production and distribution of capital there is a constant conversion of capital into income, and *vice versa*.

8. The attempt to conceal this conversion by treating "income" as the standard return from intact "capital" only leads to confusion of the value of capital with capital itself.

The propositions applicable to the present cases.

The manner in which the instant cases have been grouped in the statement with which this brief opens indicates in broad fashion the concrete questions which they present. In Group I (*supra*, p. 4) surplus earnings accumulated prior to the taxing year were distributed during the taxing year in dividends. Was this surplus a part of the stockholder's nontaxable capital when the year began, or was the accumulation merely a circumstance which enhanced the capital value of his investment by the prospect which it afforded of future income in the shape of dividends? Did not the income accrue at the moment this prospect was realized upon and not before?

In Group II timber and ore lands were purchased or leased with a view to their operation or resale. They appreciated in value between the time of purchase and the beginning of the taxing year. May the owner deduct from the proceeds of their sale or operation realized during that year a sum equivalent to this enhanced value, claiming it as a part of his nontaxable capital; or is not his gross income measured, in regard to both amount and time, by the total sum realized upon the conversion or transfer of these assets?

In Group III corporate stock purchased before the taxing year was resold during the year for a sum exceeding its original cost. May the owner deny that the transaction produced any income whatever; or

may he compute it by deducting from the selling price, not the original cost of his investment but its enhanced capital value as of the beginning of the taxing year? Can this enhancement be treated either as capital or as income until the moment comes when it is actually realized?

It is evident that these questions are cognate in character and should be resolved upon principles of general application. Keeping in mind the definitions which have been attempted, the following propositions are believed to be decisive of the problems which the cases present:

1. Income being derived from the use of capital, the conversion or transfer of capital always produces income.
2. Mere appreciation of capital value does not produce "income," nor mere depreciation "outgo."
3. Net income is the difference between *actual* "income" and *actual* "outgo."
4. "Income" is not confined to money income, but includes anything capable of easy valuation in money.

1. Income being derived from the use of capital, the conversion or transfer of capital always produces income.

(a) In general the income arising in business transactions and taxable under income tax acts comes, as a matter of fact, from the conversion and sale of labor and commodities. The laborer sells his brawn for his daily wage; the merchant turns his stock of

goods over into cash; the manufacturer converts the raw material into the finished product and sells it; and the miner extracts his ore solely with a view to its consumption or sale. If the claim that no income arises from the conversion or transfer of capital be true in any broad sense there will be practically no object left for an income tax act to operate upon.

This can not be denied. The claim, however, is advanced in a more restricted form, namely, that the conversion or transfer of so-called "permanent" or "fixed" capital produces no income, but is a mere realization or return of capital. There is nothing, however, in the general principles relating to income as distinguished from capital which justifies this distinction. The income of any person or business is derived indiscriminately from the use, conversion, and transfer of "permanent" and "circulating" capital alike; and it is impossible to draw the line between them for purposes of income taxation. For instance, an attempt is made to distinguish between the sale of stocks or bonds by an investor and their sale by a broker. In the one case, it is said, they produce income, in the other they do not. The only difference between the two cases, however, lies in the intent of the owner of the capital as to whether he is dealing in the particular stocks and bonds as a business or not. This raises questions impossible of administrative or judicial determination. For example, many so-called investors deal in stocks to a large extent. Again, as in the case at bar of the

Cleveland, Cincinnati, Chicago & St. Louis Railway Co., No. 593, the stock may have been bought, not for its intrinsic qualities as a permanent investment, but merely to further the general business interests of the corporation. It is, therefore, as a practical matter, impossible to say whether certain capital is, under all the circumstances of a particular case, "permanent" or "circulating."

It is clear that "income" is in fact received by the owner of capital upon its conversion or sale, whether that capital be called "permanent" or "circulating"; nor is there any difference in the nature of the income, in and of itself, from whatever source it be derived. There may be a moral, or in some cases, perhaps, a legal obligation to reinvest the income in capital, but this concerns only the use to be made of the income, not its real character. Whether it is used one way or the other may affect the *value* as a whole of the owner's *capital*, but can not in the nature of things affect the fact that income *was* received. Furthermore, the particular income tax act under consideration may with wisdom provide that such receipts shall not be included in income. If, however, no such provision be made, general principles force the conclusion that income in fact accrues when "permanent" capital is converted or sold, just as truly as when "circulating" capital or personal abilities are used in the same way.

(b) In so far as the two statutes under consideration are concerned, it should be especially noted that,

while the Civil War income tax acts used the words "*annual profits and gains*" for the year, the strikingly different language employed by Congress in the Corporation Tax Act and in the Income Tax Act of October 3, 1913, indicates strongly that, though an annual period was retained, income of every character and from every source was to be included. There is certainly no provision which can fairly be taken to provide that the proceeds of the sale or conversion of capital assets are *not* to be included in "gross amount of income." *Payments* on account of such capital are excluded by the proviso in the second paragraph of Subsection B of the Income Tax Act:

That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate.

This provision is similar to, though less comprehensive than, that contained in Rule 3 of the First Case of Schedule D of the English income tax acts, which disallows any deduction for capital withdrawn, for sums employed as capital, or for capital employed in the improvement of the premises.

These provisions undoubtedly draw a line between payments on account of permanent capital and ordinary expenses, and to that extent the statute makes the term "net income" more inclusive than we have argued it is on general principles. Nevertheless they do not show a legislative intention to limit income to those receipts only which do not arise from the sale or conversion of "permanent capital." In fact the

inference from them is to the contrary (as shown by the English decisions on them, *e. g.*, *Coltress Iron Co. v. Black*, 6 App. Cas. 315; *Alianza Co. v. Bell* (1906), A. C. 18), for if *payments* on account of permanent capital can not be deducted, *a fortiori* no *allowance* can be made therefor out of the proceeds of sale of such capital, which must therefore be brought into income account as a whole.

(c) We come then to the authorities dealing with the proposition on general legal principles.

In *City of London Contract Corporation v. Styles* (1887), 2 Tax Cas. 239, it appeared that the company, by the payment of a large sum down, had acquired certain unexecuted contracts which represented its capital. It was held that the proceeds derived from the contracts were income and that the price paid for them could not be deducted. In *Gillatt v. Colquhoun*, 2 Tax Cas. 76, it was held that the original premium paid for a leasehold could not be deducted from the income derived from the lease (although this income must have been partially derived from this premium). In *Delage v. Nugget Polish Company* (1905), 92 Law Times Rep. 682, the vendor of a secret process sold upon the basis of a percentage of the gross receipts for a certain number of years was held liable to income tax, though the receipts were clearly "capital" receipts.

In *Scoble v. Secretary of State*, 4 Tax Cas. 618, (1903) 1 K. B. 494, (1903) A. C. 299, a railroad was sold for a lump sum payable in annual installments with interest, and it was held that the annual

installments were mere payments of a "capital" debt and hence were not income. The opinions of the judges all rest on the proposition that to tax payments on account of "capital assets" would be to tax capital and not income. On the other hand, in *Blake v. Imperial Brazilian Ry.*, 2 Tax Cas. 58; *Nizam's Guaranteed Ry. Co. v. Wyatt*, 2 Tax Cas. 584, 24 Q. B. Div. 548; and *Pretoria-Pietersburg Ry. Co. v. Elwood*, 6 Tax Cas. 508, 98 Law Times Rep. 741, payments which were clearly made up partly of interest and partly of "capital" payments were held to be all income. And in *Delage v. Nugget Polish Company, supra*, Phillimore, J., evidently doubted the principle upon which *Scoble v. Secretary of State, supra*, was rested and thought it could only apply where there was a specific capital debt fixed at the outset.

In *Northern Assurance Co. v. Russell*, 2 Tax Cas. 551, 578, it was held as to investments made by fire and life insurance companies:

(5) Where the gain is made by the company (within the year of assessment or the three years prescribed by the income tax act, schedule D), by realizing an investment at a larger price than was paid for it, the difference is to be reckoned among the profits and gains of the company.

In *Scottish Investment Trust Co. v. Forbes*, 3 Tax Cas. 231, it appeared that the company was formed to invest its capital in stocks and bonds and to vary its investments by sale, etc. It was held that the gain made

by realizing investments at larger prices than were paid for them must be included in the account and that depreciation in value of other investments could not be set off against it. The Lord President said (pp. 234, 235):

My view of this company is, therefore, that its position in the present question is entirely distinguished from that of a private individual or an ordinary trader. Accordingly, I think that it is wrong in its contention that increases on realization of stocks of the company are capital sums, and therefore not liable to assessment for income tax.

In *Assets Co. v. Forbes*, 3 Tax Cas. 542 (a case of a company formed to liquidate the assets of an insolvent bank), the two previous decisions were somewhat limited. Lord Young said (p. 548):

I should say that I have really no doubt that any person, or any company making a trade of purchasing and selling investments, will be liable in income tax upon any profit which is made in that trade. * * * But it is another proposition altogether that, where that is not a trade, a gain or loss upon the purchase and resale of property comes within the meaning of the income tax acts.

In *Californian Copper Syndicate v. Harris*, 5 Tax Cas. 159, it appeared that the company had been formed to acquire, work, and dispose of copper and other mines. It purchased a mine and subsequently sold it at an advance, taking in payment paid-up shares in the vendee company. This practically

exhausted its capital (p. 162; Finding VI). It was held that the difference between the purchase price and the value of the shares received was assessable income. Lord Justice Clerk said (pp. 165, 166):

It is quite a well-settled principle in dealing with questions of assessment of income tax, that where the owner of an ordinary investment chooses to realize it, and attains a greater price for it than he originally acquired it at, the enhanced price is not profit *in the sense of schedule D of the income tax act of 1842 assessable to income tax*. But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. [Italics ours.]

In *Hudson's Bay Co. v. Stevens*, 25 Law Times Rep. 709, 5 Tax Cas. 424, the company surrendered its territory and rights of government to the Crown and received in payment (*inter alia*) a land grant. It was held that the proceeds of sale of the land so granted was not assessable in income tax. Farwell, L. J. (5 Tax Cas. 437), drew a distinction between the ordinary owner of land selling it, and a real estate trader doing the same thing; in the latter case the Income Tax Act was applicable, in the former not. He thought the company came within the former class. The same view was taken in *Tebrau Rubber Syndicate v. Farmer*, 5 Tax Cas. 658, and it was held

that the syndicate was not organized for the purpose of selling its rubber plantation, but of working it, and that, therefore, the profit from the sale "is not part of the person's annual income liable to be assessed for income tax but results from an appreciation of his capital" (5 Tax Cas. 664, 665).

It must be remembered in determining the application of these English and Scotch decisions to the cases at bar that the act under consideration therein did not use the word "income" at all, but merely "profits"; that its basis was "the full amount of the balance of profits or gains" for an annual or triennial period; and that it was restricted to a "trade, manufacture, adventure, or concern." Even, therefore, where it was decided that under certain circumstances conversion of "capital assets" did not produce assessable "profits," the decisions are not necessarily in point under an act which either does not use "profits" or "gains" at all or but incidentally, and which starts with a basis of gross amount or total amount of income from all sources.

In *Taxation Commissioners v. Mooney* (1907), A. C. 342, 350, the Privy Council said as to the act of New South Wales taxing incomes more generally:

They [the Privy Council] agree with the High Court that a change in the form of property by a person who does not traffic in that kind of property can not be regarded as producing income taxable under the Income Tax Acts.

In *Kauri Timber Co. v. Commissioner of Taxes* (1913), A. C. 771, it was held that the proceeds of lumber sold by the company was income even to the extent of that portion derived from the conversion of standing timber into lumber. The New Zealand Act prohibited the deduction of "expenditure of capital" and "loss of capital." The decision, however, was mainly placed upon the general principle "to the effect that the consumption of capital can not be treated in the ascertainment of profits as a revenue debit" (p. 778); i. e., the conversion of capital invested in timberlands produces income, just as it does in the case of mines:

The law—so clearly settled with regard to the working of coal and of nitrates, and settled upon a broad general principle—is in no way different when it comes to be applied to timber-bearing lands (p. 778). [Italics ours.]

In *Commissioner of Taxes v. The Melbourne Trust* (1914), A. C. 1001, the Trust (like the company in *Assets Co. v. Forbes, supra*), was formed to realize on the assets of certain insolvent banks but not apparently for the benefit of the creditors as such. It was held that the proceeds of sale of the assets were income. The Privy Council approved the rule quoted, *supra*, from *Californian Copper Syndicate v. Harris*, 5 Tax Cas. 159, and held that the Trust was in effect a trading company formed to sell at a profit. In *Wallaroo and Moonta Mining Co. v. Commissioner of Taxes*, (1907) S. A. Law Rep. 64, (1914) *ibid.* 207; S. C. *sub. nom. Davidson v. Commissioner of Taxes*

(1917), A. C. 542, the proceeds of sale of a large amount of ores accumulated for several years and sold in 1903 because of the favorable condition of the market was held to be profits for 1903. In *In the Matter of the Income Tax Acts*, 25 Victorian Law Rep. 679, 682, it was held that the proceeds of sale of certain shares of stock by a person not trading in such things was not income:

This money is an accretion to the taxpayer's capital, and not income.

Coming to the authorities in this country the Wisconsin cases cited, *infra*, are all to the effect that the conversion of capital assets produces income except *Bundy v. Nygaard*, 163 Wis. 307, in which it was held that where certain shares of stock were purchased before the going into effect of the Wisconsin Income Tax Act by an individual as an investment and not merely for resale, and were sold after the act went into effect, the proceeds of sale were not income. The court said that "income" in the act had its "common, ordinary meaning," and that the value of the stock had become "capital" prior to the passage of the act and must be taxed as such. In *Sallie F. Moon Co. v. Wisconsin Tax Commission*, 163 N. W. Rep. 639, 641, Winslow, C. J., attempts to reconcile the decision in the *Bundy* case with that in *Van Dyke v. Milwaukee*, 159 Wis. 460, but his statement that where A and B exchange property, B may have income though A has none appears to be itself in need of explanation. The

cases can be reconciled if the distinction taken in the English and Australian cases be sound, namely, that capital is "permanent" or "circulating" according to the *animus* of the owner. If that distinction be not sound, the *Bundy* case seems contrary to the other decisions of the Supreme Court of Wisconsin.

The attention of the Court is especially invited to the decisions of the Supreme Court of Wisconsin in *Pfister v. Widule*, 168 N. W. 641, and *Nunnemacher v. Widule*, *ibid.*, 644, because they raise the question of real estate sales. In those cases the companies were formed to purchase, subdivide, and sell certain tracts of land, and acquired the same prior to the effective date of the Income Tax Act. It was held that proceeds of sale of land distributed to the stockholders subsequent to the going into effect of the act was income to them.

The Civil War income tax acts were not levied on "net income received," or "net income arising or accruing" "in the preceding calendar year," nor did they contain a provision for a return of "the gross amount of the income" from all sources less certain specific deductions. On the contrary, the tax was levied on "the annual income" (act August 5, 1861, 12 Stat. 292, 309, sec. 49), "the annual gains, profits, or income" (act July 1, 1862, *id.* 432, 473, sec. 90; act June 30, 1864, 13 Stat. 223, 281, sec. 116); and return was required "of the amount of income" (act July 1, 1862, sec. 93; act June 30, 1864, sec. 118). Accord-

ingly it was said in *Bailey v. Railroad Co.*, 106 U. S. 109, 114:

It should be borne in mind, in the first place, that the tax provided for in this section is an annual income tax, and its subject is the interest paid and profits *earned* by the company for each year, and year by year;
* * *. [Italics ours.]

In other words, the Civil War Acts could be taken to levy a tax merely on the balance of periodical profits and gains from transactions begun and completed within the year.

The case of *Bailey v. Railroad Company*, although it held that the tax was not leviable on that portion of a scrip dividend which came from profits accumulated prior to the passage of the act, is not particularly significant because of the doubt whether the tax was levied on the stockholder or on the corporation. If on the latter, we do not claim that receipts and expenses of one year need be taken into the income account of another.

In *United States v. Smith*, 12 Int. Rev. Rec. 135, 138, Judge Deady held that "the defendant was bound to state and return for taxation as income all gains and profits derived from the sale of stocks in 1868, whenever purchased," provided the purchase was since the passage of the Income Tax Act of August 5, 1861. In *Merchants' Ins. Co. v. McCartney*, 12 Int. Rev. Rec. 122, 1 Low. 447, Judge Lowell held that an extraordinary cash dividend derived from surplus accumulated prior to the passage of

the act was not taxable as income, gains, or profits, but was a "division of capital." This case, however, like *Bailey v. Railroad Co.*, *supra*, may be explained on the ground that the tax was in reality on the corporation and not on the stockholder. (See *Railroad Co. v. Collector*, 100 U. S. 595, 598, and *United States v. Erie Railway Co.*, 106 U. S. 327, 330.)

In *Gray v. Darlington*, 15 Wall. 63, the court (the Chief Justice and Justices Clifford and Bradley dissenting) held that where an individual purchased United States bonds in 1865 and sold them in 1869 at an advance, no portion of the proceeds of sale was "gains, profits, or income" for the year 1869. The court quoted the act under consideration and said of it (p. 65):

This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits *as may be realized from a business transaction begun and completed during the preceding year.* [Italics ours.]

If the authority of this case be confined to a ruling upon the exact language of the act of March 2, 1867, 14 Stat. 471, 477, 488, c. 169, so construed, it is clearly not applicable to the case at bar. The Corporation Tax Act and the Income Tax Act of October 3, 1913, can not be construed in this manner, for their basis is not "annual gains, profits or income," or the "gains, profits or income

for the year," but the "net income received from all sources" during the year, "the entire net income arising or accruing from all sources in the preceding calendar year," and this in its turn is to be determined from "the gross amount of the income" "received," or "accruing" from all sources during the year. Such a difference in the terms of the act clearly shows a difference in the intention of Congress, and makes it impossible to construe the later acts as excluding by their express terms the proceeds of sale of investments. *Gray v. Darlington*, however, may be based partly upon the distinction alluded to above between capital destined by its owner for sale and that destined for investment, and this is perhaps borne out by the statement of the court that the rule laid down would not apply to the ordinary stock in trade of a merchant; and by its evident view that to tax the proceeds of sale in the case before it would be to tax capital, i. e., all receipts on account of the bonds in excess of their regular interest would be capital receipts and not profits.

In *Stratton's Independence, Limited, v. Howbert*, 231 U. S. 399, and *Stanton v. Baltic Mining Co.*, 240 U. S. 103, this court held that the proceeds of sale of "capital assets" invested in a wasting enterprise were income to some extent, but left open the question whether a portion might not be excluded under the provision for "depreciation." In *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, it was held that, where the statute did not otherwise provide, all such proceeds were income.

Notwithstanding conflict here and there, the conclusion from these authorities clearly is that as a general thing the conversion or transfer of capital produces income. Only one exception is recognized. Where the capital is in its nature permanent, and its owner holds it for investment and not for sale, the proceeds of sale are not income; but where the capital, though permanent, has been, or partial rights therein have been acquired as part of a regular trade or business to be disposed of if the ordinary ends of the business make it profitable so to do, the proceeds of sale are income. In the cases at bar we have to do with stock of one railroad purchased and sold by a connecting carrier; with stock of one colliery company purchased and sold by another engaged in the same business; with timber held and manufactured by a company chartered solely for that purpose; with ore deposits owned or leased by mining companies engaged in their exploitation. It can not be pretended that these investments constituted permanent as distinguished from circulating capital, or that they were not acquired in the regular course of trade or business, with a view to their ultimate disposition whenever it became profitable so to do.

It is not clear, moreover, that even those who propound this exception go on the broad ground that the proceeds of sale of permanent capital are never income at all; but rather that they are not taxable income within the meaning of the particular statutes then under review. There is nothing, however, in

the language of the Corporation Tax Act or of the Income Tax Act of October 3, 1913, which would justify such interpretation. On the contrary, their express terms preclude it. The provisions as to "depreciation," while they may be taken to exclude as income part of the services of both permanent and circulating capital, clearly have no application to conversion or sale of capital.

2. Mere appreciation of capital value does not produce "income," nor mere depreciation "outgo."

The cases at bar present in two forms the question of the place to be given in income accounting to the mere appreciation of capital. It is claimed that in so far as there has been an appreciation in value prior to the beginning of the taxing year, it is either a mere enlargement of capital assets, which when converted, produces no income, or is income previously accrued, and therefore not to be accounted for as such even though received during the taxing year.

These theories are expounded by the courts below in *Lynch v. Turrish*, No. 491, and *Doyle v. Mitchell Bros. Co.*, No. 492, which are now under discussion. In the *Turrish* case, a corporation acquired certain timberlands with the purpose of reselling them at a profit. Between the time of their purchase and March 1, 1913 (the effective date of the Income Tax Act), they had largely increased in capital value, owing, it may be assumed, partly to growth and partly to supply and demand. The corporation sold them at an advance after March 1, 1913, and dis-

tributed the proceeds to its stockholders. The court held that these proceeds were not income. It may be said, with respect, that it is not easy to identify the exact ground of its opinion, but apparently the court, while relying on the proposition that a sale of "capital assets" never produces income, also thought that if there was any income at all it had "accrued" prior to March 1, 1913. (R. No. 421, pp. 22, 24-27; 236 Fed. 653, 655.) The *Mitchell Bros. Co.* case is similar in character, except that the timber was not sold but was manufactured into lumber. The court held that the proceeds from the sale of this timber, in so far as they represented advance of capital value of the timber on January 1, 1909 (the effective date of the Corporation Tax Act), were not income. This opinion also goes in part on the proposition that the sale or conversion of capital assets does not produce income, but it clearly states the theory that appreciation of capital is income "accrued" prior to the taxing year. The court said (R. No. 492, pp. 132-134; 235 Fed. 686, 689, 691):

* * * Whatever would be income for 1909, if it accrued after January 1st had become income on that day if it had accrued in the earlier period.

So, too, if a loss by depreciation is to be deducted, a gain by appreciation must be added.

And the court finally adopted this definition:

* * * We may say that the appreciation therein [capital value] and gain thereupon

during the period and found at its end in realizable form is income.

This conclusion is believed to be unsound both on reason and authority.

(a) The view that appreciation or depreciation of capital should be taken into account in estimating income is due to the failure to distinguish between "income" and mere gain or loss of "capital value." There may be a sense in which capital may be said to be doing its owner a service or disservice, merely by increasing or decreasing in capital value from day to day or from moment to moment, but it is a sense which can not be usefully employed in determining what is income in practical affairs. The rise or fall in capital value from time to time may show that something has happened to the article which has affected its future income-bearing capacity, but what that something is must be left, in so far as the determination of actual income for practical purposes is concerned, to the time when the income is actually realized. There is no harm in making entries on the books crediting or charging such portion of this appreciation or depreciation as is proper to any particular year. By so doing the difference is shown between what the business actually earned during the year and what it should have earned according to the standard of a normal return for the particular class of invested capital, to the end that such deficiencies may be made good in the future or abnormal returns may not lead to extravagance. Treating,

however, such appreciation or depreciation as though it were actual income or outgo can only lead to confusion. It is believed that no one would ever claim that such appreciation or depreciation in "permanent" capital should ever be treated as actual "income" or actual "outgo."

The fact that the farm or mine, the factory or office building, the patent or good will, is worth more or less at one period than another would never be taken to indicate that the profits of the business were greater or less during that period. If a man own a vacant lot which produces no income during a period of years but which is steadily rising in capital value during that period owing to the growth of population, can it be said that this appreciation represents income arising or accruing to him during that period? Is so-called "unearned increment" income? We know it is not taxed as such in States where it is taxed at all. If a man own a rented house, is the amount of rental he receives, less his taxes, insurance, repairs, etc., his net income, or must there be a further deduction for the gradual depreciation of the house, though he has paid out nothing on account thereof? There can, it seems, be only one answer to these questions. So as to capital in human abilities. No one would claim that in such case a deduction should be made from income to cover the loss of ability from sickness, age, or the like. The claim for an allowance for appreciation and depreciation in income accounts is only seriously urged in regard to

what is called circulating capital. Here it is true that, the goods being held for immediate sale, and their "capital value" therefore approximating their immediate selling price, the loss in value is more apparent and proximate and will sooner have to appear in income accounts than in the case of permanent capital. This, however, seems to be no reason to disregard general principles by calling that a gain or loss in income which is not *in fact* such, because it *soon may be*.

(b) The statutes under review do not throw much light on this proposition. They neither of them mention "appreciation," but both of them provide for an allowance for "depreciation." Depletion or conversion of "capital assets," however, is not depreciation, and while, of course, Congress might allow it in the form of a deduction, the real meaning of such provision would be that the proceeds of "capital assets" to the extent provided are not taxable income.

There is also the provision in the Income Tax Act that taxable income shall include undistributed profits of corporations under certain circumstances of fraudulent withholding, which may be taken to mean that accretions to capital are sometimes income, but the matter is dealt with in too special a manner to be of much assistance.

(c) Is the view of the courts below sustained by authority? In our judgment it is not. No case has been found which squarely so holds, while several cases seem to the contrary. In *Commissioners of*

Taxation v. Kirk (1900), A. C. 588, the question was the taxation of a mining property under the laws of New South Wales. The Privy Council said (p. 592):

It appears to their Lordships that there are four processes in the earning or production of this income—(1) the extraction of the ore from the soil; (2) the conversion of the crude ore into a merchantable product, which is a manufacturing process; (3) the sale of the merchantable product; (4) the receipt of the moneys arising from the sale. All these processes are necessary stages which terminate in money, and the income is the money resulting less the expenses attendant on all the stages.

Here there is no notion that the income accrued as the capital value increased.

In *Burnley Steamship Co. v. Aiken*, 3 Tax Cas. 275, it was held that the diminished value of a ship owing to increased competition of better ships could not be deducted from income but was a "capital" matter under the English Acts. In *Commissioners of Taxation v. Antill* (1902), A. C. 422, it was held that depreciation of a leasehold could not be considered a "loss" under the New South Wales Income Tax Act. In *Kauri Timber Company v. Commissioner of Taxes* (1913), A. C. 771 (where the Privy Council held directly the contrary of the decision of the Circuit Court of Appeals in *Doyle v. Mitchell Bros. Co.*), it was said (p. 776):

So long as the timber, at the option of the company, remained upon the soil, it derived

its sustenance and nutriment from it. The additional growths became ipso jure *the property* of the company. [Italics ours.]

In *Wallaroo and Moonta Mining and Smelting Co. v. Commissioner of Taxes*, (1907) S. A. Law Reps. 64, (1914) S. A. Law Reps. 207, S. C. sub. nom. *Davidson v. Commissioner of Taxes* (1917), A. C. 542, it was held that the sale of certain copper in 1908 was "profits" for that year. The copper had been accumulated for several years and was sold in 1908 for the reason that the price of copper had risen at that time. Counsel in argument before the Privy Council said ((1917), A. C. 544):

The tax is upon income. The profits for a year are not affected by variation in the value of assets.

This was evidently the view of the courts.

In *United States v. Kansas Pac. Ry. Co.*, 99 U. S. 455, 459, this court said:

First. "Depreciation account, or expense not charged up." This is explained to be the amount necessary to put the road in proper repair, but which was not actually expended for that purpose. We are clearly of opinion that it is not a proper charge. Only such expenditures as are actually made can with any propriety be claimed as a deduction from earnings.

In *Gray v. Darlington*, 15 Wall. 63, 85, the court said:

The advance in the value of property during a series of years can, in no just sense, be con-

sidered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property.

On the other hand, in *Little Miami etc. R. R. Co. v. United States*, 108 U. S. 277, depreciation in the value of investments and of tracks was held to be a proper deduction in the ascertainment of "profits."

In *Gibbons v. Mahon*, 136 U. S. 549, it appears to be held (in so far at any rate as the earnings of the corporation made after the inception of the trust were concerned) that increase in value of corporate stock owing to accumulated surplus of the corporation is not income of the shareholder. The court said (p. 558):

Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein, represented by each share, is capital, and not income, of that share, as between the tenant for life and the remainderman, legal or equitable, thereof.

In the similar case of *Spooner v. Phillips*, 62 Conn. 62, the court said (p. 68):

The word "income" has a broader meaning, but hardly broad enough to include things not separated in some way from the principal. It is not synonymous with "increase." The value of stock may be increased by good management, prospects of business and the like, but such increase is not income. It may also be increased by an accumulation of surplus;

but so long as that surplus is retained by the corporation, either as surplus or increased stock, it can in no proper sense be called income. It may be income-producing, but it is not income.

In *Baldwin Locomotive Works v. McCoach*, 215 Fed. 967, Judge Dickinson held that an increase in the estimated value of a corporation's assets was not income. He said (p. 972):

As the act does not provide that any increment in value shall be added to the gross income, whence comes the authority to add to it?

This judgment was affirmed by the Circuit Court of Appeals (221 Fed. 59).

In *Edwards v. Keith*, 224 Fed. 585, 231 Fed. 110, it was held that an insurance agent's commissions on renewal premiums were income "arising or accruing" to him for the years in which they were paid, although it was admitted that he had a "property" in them prior to March 1, 1913. This court refused a writ of certiorari in this case (243 U. S. 638).

In addition the decisions of this court in *Stratton's Independence, Limited, v. Howbert*, 231 U. S. 399, and *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, while mainly in point on the proposition that a conversion or transfer of "capital assets" may produce income, yet would not have been rendered if this court had supposed that rise or fall in the market value of such assets produced profit or loss

to the owner at the time of such change. The same thing may be said of the decisions of the Supreme Court of Wisconsin in *Van Dyke v. Milwaukee*, 159 Wis. 460; *State ex rel. Sallie F. Moon Co. v. Tax Commission*, 163 N. W. 639; *State ex rel. Pfister v. Widule*, 163 N. W. 641; *State ex rel. Nunnemacher v. Widule*, 163 N. W. 644; *Pfister Land Co. v. City of Milwaukee*, 165 N. W. 23 (but see *State ex rel. Bundy v. Nygaard*, 163 Wis. 307).

Nor, in spite of the opinion of the Supreme Court of Wisconsin referred to above in *Sallie F. Moon Co. v. Tax Commission*, 163 N. W. 639, does the employment in the Income Tax Act of October 3, 1913, of the words "arising or accruing" instead of the word "received" used in the Corporation Tax Act, indicate an intention on the part of Congress to include all unrealized appreciation and depreciation of capital in income. The deductions allowed all consist of actual payments, except the allowance for depreciation, which is so limited in terms as not to include a mere fall in market value and even to the extent allowed only emphasizes the general purpose of the act to consider only actual receipts and payments. The return provided for starts with "the gross amount of income from all separate sources" (omitting the expression "arising or accruing"). Moreover, in the case of corporations, the return expressly starts with "the gross amount of the income received" within the year from all sources (Subsection C (b)), and it is not to be supposed that Congress

intended appreciation and depreciation to be included in the case of individuals but not of corporations.

2. Net income is the difference between actual "income" and actual "outgo."

(a) What has been said to the effect that mere appreciation or depreciation of capital can never (on general principles) be correctly entered in income accounts has a bearing to some extent on the present proposition. That proposition, however, is in reality different. We are now inquiring, not whether a *mere difference in the estimate* of the future income-producing capacity of capital shall be entered in income accounts, but whether *actual* receipts and payments should always be entered in income account or whether they should be in certain cases charged or credited to capital account. The connection, therefore, is rather with the proposition that the proceeds of the conversion of capital is income.

(b) There can be no doubt that in the normal case net income is made up simply of actual receipts less actual expenses and that the term is generally used in this sense. Frequently, however, the term "net income" (and especially its synonym "profits") is used by business men, accountants, and courts as meaning that annual, regular income which will leave capital value intact; that income for the production of which the particular capital in question exists or was acquired. When the conception at the basis of this use of the term is analyzed, it will be found

that the vital distinction is that already alluded to, namely, between "permanent" and "circulating" capital, defining these terms not entirely by their physical characteristics as stable or unstable, but also partly by the use to which they are destined by the owner. For example, land or buildings are "permanent" capital to the farmer or manufacturer, but "circulating" capital to the real estate speculator.

Having by the test of physical characteristics and the *animus* of the owner determined that certain "capital" is permanent, all payments or receipts on account of it will (according to this view) be considered "capital" payments or receipts and will not be considered as part of the annual income or outgo. On the other hand, if the article be by the same tests "circulating" capital, payments or receipts on account of it will be considered "net income" payments or receipts, and it will be held erroneous accounting to charge or credit them to "capital." The leading case on the subject (apart from any question of income-tax legislation) is *Verner v. General Investment Trust* (1894), 2 Ch. 239, where it was held that in the case of a company formed to buy and sell investments dividends could be paid on the actual profits of the year without first taking into account depreciation of investments held by the company.

The whole matter will be found discussed also in Lindley on Companies, Vol. I, pp. 543, 598-602, and

in Buckley's Law of Companies, pp. 652-659. The latter has the following statement on page 653:

In some cases the distinction here pointed to has been conveniently expressed by the use of the terms "fixed capital" and "circulating capital" (e). The capital of the company at any particular moment is represented of course not by the money originally subscribed, but by the property bought with it and owned at that moment by the company. The author would define "fixed capital" as property acquired and intended for retention and employment with a view to a profit, as distinguished from "circulating capital," meaning property acquired or produced with a view to resale or sale at a profit. The appreciation or depreciation of fixed capital need not (or, perhaps more accurately need not in every company (f)), but that of circulating capital must be the subject of entry in the profit and loss account.

The same subject has been considered and the same distinctions recognized (though with proper limitations, to meet differing conditions) by this court in *Union Pac. R. R. Co. v. United States*, 99 U. S. 402; *Illinois Central R. R. v. Interstate Commerce Commission*, 206 U. S. 441; *Knorrville v. Water Co.*, 212 U. S. 1; *Kansas City So. Ry. v. United States*, 231 U. S. 423, and other cases.

It is evident that this distinction between receipts and payments on account of "permanent" capital and receipts and payments on ac-

count of "circulating" capital has this advantage, upon which it probably rests, namely, that it prevents "capital" payments or receipts from being considered from the point of view of the single year in which they occur. If accounts are not kept in this way "capital" receipts will swell the profits of a single year out of their true proportion to other years, because it is well understood that such receipts will cause payments in subsequent years for the purpose of creating, acquiring, or maintaining "permanent" capital, and will therefore appear in those years as expenses. So capital payments or outgo would show a disproportionate loss for the year in which they occurred, though balanced in later years (if wisely expended) in larger receipts. The payments and receipts on account of "circulating" capital, however, will tend to be similar in every year and will not be "spread" over the future years.

If the desire be to show the true financial condition of the business, taking a stand at an instant of time and looking backward and forward for a proper space (as it certainly is from the point of view of the owners of capital, the creditors, and the general public), then the "capital" payments and receipts must be separated from the "net income" payments and receipts. Otherwise the business will appear as a series of hills and valleys, whereas, in truth (taking it over a period of years), it will approximate a plane, because the hills will be removed and the valleys filled. Is this distinction,

however, between "capital" and "income" payments and receipts useful to determine what is the true "net income" of a business for taxing purposes as well as to determine its true financial condition at an instant of time? It can not be denied that a legislature (even restricted as Congress may be in the levying of property taxes), could expressly provide that "capital" payments and receipts should not be brought into income accounts, for what would be left in that event would still be income as distinguished from capital. But, assuming that the legislature has not done this, does the mere use of the term "net income" of itself exclude all capital receipts or draw any distinction between those from permanent and from circulating capital? This distinction, as has been pointed out, has, confessedly, a limited operation. It only applies to so-called "permanent" capital in certain businesses, and it is dependent, as has been stated, on the animus of the owner, so that the same thing may now be "permanent," now "circulating," capital. Even if the animus be assumed as of a certain character, he would be wise beyond most men who could draw the definite line between "permanent" and "circulating." In *Dovey v. Cory* (1901), A. C. 477, 486, 487, Lord Chancellor Halsbury said:

I doubt very much whether such questions can ever be treated in the abstract at all. The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in deter-

mining the question what may be treated as profits and what as capital. Even the distinction between fixed and floating capital, which may be appropriate enough in an abstract treatise like Adam Smith's "Wealth of Nations," may with reference to a concrete case be quite inappropriate.

This court in the cases cited above approved certain charges to "capital" for certain purposes which it could not approve for other purposes.

The fundamental objection to the distinction is that it does not conform to facts, but rests at last upon a fiction. It refuses to call that income which is, in fact, income and that outgo which is, in fact, outgo. For the purpose of getting a broad view of capital over a series of years, it assumes that money which has been received in one year has *in fact* not been received at all or has been received in regular annual installments, and that payments which have been made in one year have *in fact* been spread over several. There is no harm in the fiction *so long as it serves a useful end and so long as it is recognized to be a fiction*. But in attempting to determine the true meaning of net income for taxing purposes, it is the fact which is important, and will lead to correct conclusions, and not the fiction.

Dealing with the fact it may be safely moulded to the shape prescribed by the legislature, or, if that shape be unsatisfactory, the legislature may intelligently modify the mould, but dealing merely with a fiction, the result (if experience proves anything) will be

merely to confound confusion. The notion that a person does not have a certain net income during a certain year because during succeeding years he will be obliged so to conduct himself as to have either a greater or less net income for those years (unless understood clearly to be a fiction adopted for particular ends) confuses the present with the future, and makes difficult the application of law to either. It is as though the spendthrift were said to be thrifty because before long his lack of money will oblige him to be so.

In the above discussion it will be noted that the term "net income" has been employed instead of the more usual terms "profits," "gains." It is not believed that these latter expressions are of material significance in the construction of either the Corporation Tax Act or of the Income Tax Act. Without question Congress could have employed either of these terms as meaning merely the excess of *ordinary* receipts over *ordinary* payments. If it has not done so, there appears to be nothing in the natural meaning of the words "profits and gains" which affects the correctness of our reasoning as to "net income." It is well known that, as a matter of fact, experienced business men do charge to "profit and loss" payments and receipts out of the ordinary. If a person buy a piece of real estate for a certain purpose and afterwards for any reason give up that purpose and sell the property at an advance, he would not hesitate to say he had made a "profit." The natural reluctance to bring into "profit and loss" account every payment

and receipt arises (as in the case of "net income") from the fact that certain of them were not made or received for the benefit of the present year only but for succeeding years also, and should therefore be represented in the accounts of those years. This, however, is but to confuse "capital value" with actual "profit and loss," and to regulate by the future what has actually occurred in the past.

The distinction between "capital" and "income" payments and receipts should not be confused with the distinction between estimated and actual income. It is impossible in the practical working of taxing acts to determine with absolute accuracy the amount of a person's income. It must to some extent be estimated. In earlier legislation in continental countries and in England, persons were arranged in social classes, and the tax (in the nature of an income tax) was graduated according to the supposed income of each class. So the present tax on owners of land in England is based on "annual value," and yet is said to be an income tax.¹ Such provisions, however, do not purport to call certain payments and receipts "capital" and not "income." They assume that all payments and receipts are income, but instead of taking the burden of establishing each particular payment or receipt, it is presumed from certain circumstances that actual payments and receipts have in fact occurred. It may be added that the tendency in legislation is to aban-

¹ See remarks of Lord MacNaghten in *London County Council v. Atty. Gen'l* (1901), A. C. 26, 35, 36.

don this method of presuming income, and to attempt, as well as the limits of administration permit, to discover the actual income.

(c) There is nothing in either the Corporation Tax Act or the Income Tax Act of October 3, 1913 (as there was perhaps in the Civil War Income Tax Acts), which warrants the claim that the term "net income" as used in them means merely the periodical, ordinary gains *earned* from an intact capital; and the decision in *Anderson v. Forty-Two Broadway, supra*, is directly to the contrary as to the Corporation Tax Act. The sweeping inclusion in both acts of the gross amount of the income from all sources, and the allowance as deductions of actual payments only, point to a net income figured on the basis of all actual receipts and expenditures. It is true that "depreciation" is allowed, but merely as a deduction, in which form it would be meaningless if so-called "capital receipts" were not to be included at all in the accounts.

It is true that there are several decisions of English courts under the English Income Tax Acts approving of the distinction between "capital" payments and "income" payments, and especially with regard to the "unearned premiums" of insurance companies. (See especially *Sun Insurance Office v. Clark* (1912), A. C. 443, 6 Tax Cas. 59). In *Vallambrosa Rubber Co. v. Farmer*, 5 Tax Cas. 529, 536, the Lord President said:

Now, I don't say that this consideration is absolutely final or determinative, but in a

rough way I think it is not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year.

And this definition was approved by Rowlatt, J., in *Ounsworth v. Vickers Limited* (1915), 3 K. B. 267, 6 Tax Cas. 671. (See also *London Cemetery Co. v. Barnes* (1917), 2 K. B. 496.)

The above definition of capital expenditure is also recognized in a general way by this court in *Kansas City Southern Ry. Co. v. United States*, 231 U. S. 423, and cases there cited, but we have found no decisions in this country applying it to income tax acts (unless *Gray v. Darlington*, *supra*, and *Bundy v. Nygaard*, *supra*, can be so interpreted), except the decision of Judge (now Justice) Clarke in *United States v. Bivabik Mining Company*, No. 594, one of the present cases. Judge Clarke, while deciding the main point in favor of the United States, held that the original amount paid for the leasehold might be spread over the whole term of the lease and deducted each year as part of the royalty (R. No. 594, p. 16). The point is not now specifically before this court, but the ruling is referred to for its authority.

The court's attention is also called to *Van Dyke v. Milwaukee*, 159 Wis. 460, 466, 467, where the claim that capital must be kept intact before income

can be said to arise was denied as to the Wisconsin acts. The recent decision of this court in *Gould v. Gould* (No. 41, October Term, 1917, decided November 19, 1917) may be referred to as having some bearing on the present question, but the case appears to rest on the peculiar relation of husband and wife, or parent and child, and to hold that payments from one to the other in performance of their legal obligations can not be considered income.

The present proposition is evidently closely connected with the one first discussed. The courts which hold that a transfer or conversion of "capital assets" does not produce taxable incomes will be inclined to hold that payments as well as receipts on account of such "capital" should not be brought into income account for purposes of taxation. It is submitted, however, that there are no authorities which justify a departure from the plain language of the acts under consideration and the substitution for the scheme laid down in the statutes of an accountant's or business man's notion of a correct profit and loss account.

4. Income is not confined to money income.

(a) Evidently it is not on principle. For example, rent is received in kind, a domestic servant or farm hand is "found," a lawyer takes shares of stock for a fee, a merchant accepts liberty bonds in payment of purchases. Here clearly there is income according to everyone's notion. For present purposes it is

sufficient to say that because of the limits of administrative machinery it is impossible to consider anything as income which is not money or capable of appraisement in money as a practical matter.

(b) The authorities all support this view. The Corporation Tax Act contained no special provision on the subject (nor is it material in the present cases), but the Income Tax Act included "compensation for personal service in whatever form paid," "sales or dealings in property," and "dividends." The mere enjoyment of a house may not constitute taxable income under some circumstances (*Tennant v. Smith* (1892), A. C. 150, 3 Tax Cas. 158), though it may under others (*Corke v. Fry*, 3 Tax Cas. 335). Such things as stocks and bonds having a regular market value have always, however, been held to be income where money would be. (*Californian Copper Syndicate v. Harris*, 5 Tax Cas. 159, 167, 168; *Income Tax Cases*, 148 Wis. 456, 518.) A dividend, therefore, like that in *Peabody v. Eisner*, No. 705, paid by distributing stocks or bonds of other companies held in the corporate treasury, is quite as certainly income as if the distribution were entirely in cash.

II.

THE SEVERAL CASES AT BAR.

It is hoped that the above discussion has rendered unnecessary any lengthy treatment of the particular cases.

Group I.

SOUTHERN PACIFIC CO. v. LOWE, No. 452.

(a) This case is in the main concerned with dividends on shares of stock paid by the Central Pacific Railway Company to the Southern Pacific Company out of profits made by the Central Pacific and turned into the surplus of that company prior to January 1, 1913. One of the dividends was the ordinary annual dividend and the other was an extraordinary dividend (R. a10). In one part of the complaint it is alleged that this surplus "*accrued*" to the *paying corporation* prior to January 1, 1913, and in another part that it "*accrued*" to the *plaintiff* (R. a10.). However that may be, the claim of the plaintiff must rest on the proposition either that appreciation of capital constitutes income under the act of October 3, 1913, or on fundamental, necessary principles which that act was powerless to disturb; or that the conversion of "capital assets" does not produce income.

(b) As to the claim that the appreciation prior to January 1, 1913, of the value of plaintiff's interest in the Central Pacific constituted income to the plaintiff during the years it occurred and not in 1914 when the dividends were paid, not only do the general principles and authorities discussed above demonstrate its un-

soundness in any case, but even the view of some authorities that appreciation of capital value may in some cases constitute income is inapplicable to the circumstances of the present case. The corporation is a distinct entity from the stockholders, the profits made prior to 1913 were made by *it*, and the surplus into which these profits were converted was *its* surplus. It is true that the stockholders have an equitable interest in such profits and surplus, but no income arises or accrues or is received by *them* until the profits or surplus of the corporation are duly distributed to them. *Gibbons v. Mahon*, 136 U. S. 549, 557, 558; *Humphreys v. McKissock*, 140 U. S. 304, 312. Evidently it would be regarded by everyone as a flagrant misuse of terms to say that a stockholder had received a certain income during a certain year because the corporation had during that year added to its surplus without any further action. Clearly, therefore, on general principles, it is improper to say that the income in question accrued to the plaintiff prior to 1913.

(c) Nor is there anything in the Income Tax Act of October 3, 1913, which can be taken to declare that these dividends were income not when they were received but when the surplus out of which they were paid was accumulated. "Dividends" are expressly included by the act in "income," and as to corporations it is provided (Sub Section G, (b)) that their net income shall be ascertained by deducting from "the gross amount of the income received within the year from all sources" certain

specific items. It certainly can not be said that the plaintiff received an income every time the Central Pacific made profits or accumulated a surplus.

(d) Assuming, therefore, that these dividends were income to the plaintiff in 1914 both on general principles and under the act, the claim that they can not be taxed because derived from capital accumulated prior to March 1, 1913, is disposed of by *Brushaber v. Union Pac. R. Co.*, 240 U. S. 1, and *Stanton v. Baltic Mining Co.*, 240 U. S. 103, and by all the authorities which hold that a tax on income is entirely different from a tax on the property from which it is derived. The *Brushaber* case decided that the effect of the Sixteenth Amendment was to wipe out the necessity for apportionment and leave the power of income taxation completely unhampered, except so far as specific provisions of the Constitution interfered. No provision of that instrument prohibits the taxation of income irrespective of its source (unless it be that relating to the taxation of articles exported or certain official salaries). It should be particularly noted that since the power to tax incomes from whatever source derived always existed under the Constitution and did not depend on the Sixteenth Amendment, the plaintiff's claim really is that there is no power to tax incomes derived from capital accumulated prior to the passage of the act, a claim which practically nullifies the power to tax incomes at all. Furthermore, on this theory incomes derived from capital situated outside the territorial limits of the United States could not be

taxed, a conclusion repudiated in *Memphis etc. R. R. Co. v. United States*, 108 U. S. 228, 234, where this court said:

To our minds it is a matter of no importance that the income came from property which was within Confederate territory. * * * The tax is payable by the person because of his income, according to its amount, and without any reference to the way in which it was obtained.

(e) It may also be claimed that since the plaintiff had an equitable interest in the nature of capital in the surplus accumulated by the Central Pacific (as it undoubtedly had), the payment of dividends constituted a mere distribution of this capital in 1914, and was not, therefore, income. We have already shown, we hope, that the fund arising from the conversion or transfer of capital is always income, both on general principles and also specifically under the act of October 3, 1913 (unless it happen to fall within one of the deductions allowed by that act, Subsection G, (b), which is obviously not the case here). Even if the distinction between "permanent" and "circulating" capital be adopted, it is settled by all the authorities that a distribution of the "surplus" of a corporation by the payment of "dividends" is not a payment out of "capital" but is a true division of profits. Lindley's Law of Companies, Vol. I, p. 601; Cook on Corporations, 7th ed., Vol. II, sec. 546, pp. 1610, 1611; "Return of a Company's Capital to its Shareholders," 26 Law Quarterly Rev. 231; *Farrington v. Tennessee*, 95 U.S. 679, 686. The question whether a "dividend"

shall be paid out of "surplus" is one within the discretion of the directors, and, especially as to taxation, their decision is final. In *Davidson v. Commissioner of Taxes* (1917), A. C. 542 (a case precisely similar to this on the question of conversion of capital assets), the Privy Council said:

* * * Their Lordships desire to say, having regard to the character of the business and the way in which it was conducted, that an investigation of the accounts presented has satisfied them that there was nothing in any law forbidding the payment of dividends out of capital which in the year 1903 would have interfered with the treatment by the company of the amounts in question as profits available for division had this course been decided on. Apart from the fact that the original capital raised by the issue of shares was in reality intact, the general assets appear to have been steadily increased by the accumulation of ore capable of being disposed of at a profit. * * *

In *Central Bank v. United States*, 137 U. S. 355, 364 (a case arising under the Civil War income tax acts), this court said:

* * * If the bank, in good faith and by mistake, made a declaration of dividends, or an addition to its surplus or contingent funds when it was not in a condition to do so, the mistake can not be corrected by the courts in an action brought to recover the tax. Relief must come from another branch of the government.

(f) The transaction involving the sale of land at Rockaway Beach by the Central Pacific (R. a10, 151, Plaintiff's Ex. C), does not require special consideration. The Central Pacific in the regular course of business took land in satisfaction of a debt, subsequently sold it, and distributed the proceeds in dividends. The matter is therefore governed by the principles discussed above.

(g) The fact that the Southern Pacific owned practically all the stock of the Central Pacific is immaterial in a case of this kind. The law is settled by the highest authority. *Salomon v. Salomon, etc. Co.* (1897), A. C. 22; *Peterson v. Chicago, Rock Island & Pacific Ry.*, 205 U. S. 364, 391-393.

In *John Foster & Sons v. Commissioners of Inland Revenue* (1894), 1 Q. B. 516, certain partners incorporated a company and conveyed all the property of the partnership to the company in return for the issuance of all its capital stock to the partners. This was held to be a "conveyance on sale" within the meaning of the Stamp Act. Lindley, L. J., said (pp. 528, 529):

But then it is argued that it is only a redistribution of property. I do not consider it a redistribution at all. It is an entire transfer of property from one set of people to another person altogether, and whether there are, as there may well be hereafter, additional persons taking shares in this company, is perfectly immaterial.

PEABODY v. EISNER, No. 705.

(a) This case is entirely governed in its main points by the principles discussed above as to *Southern Pacific Co. v. Lowe*.

(b) The case is, of course, not ruled by *Towne v. Eisner* (No. 563, decided by this court on January 7, 1918), because the dividend of the Baltimore & Ohio shares, while in "stock," was not a "stock dividend." The company parted with a portion of its assets and distributed them to its stockholders and the transaction did not differ from a cash dividend. That "income" may consist of money's worth as well as of money is demonstrated by the principles and authorities stated above, and is also clearly brought out by the decisions of the Supreme Courts of Connecticut and Massachusetts where, although the law of these States is settled that "stock dividends" are capital, it was held that dividends of the shares of stock of another corporation, although the latter was entirely controlled by the dividend paying corporation, were income. *Union etc. Trust Co. v. Taintor*, 85 Conn. 452, *Gray v. Hemenway*, 212 Mass. 239.

Group II.

DOYLE v. MITCHELL BROS. CO., No. 492.

(a) This case arises under the Corporation Tax Act, and the claim of the respondent must be that as to a corporation engaged in the manufacture and sale of lumber, using in the process timber cut from its own land, either the appreciation in value of said timberland constituted income "received" by it

during the time it occurred, or that the cutting of such timber and conversion of it into lumber was a realization of "capital assets" and therefore did not produce income in the year the lumber was sold. The case is clearly governed by *Stratton's Independence, Limited, v. Houbert*, 231 U. S. 399, *Stanton v. Baltic Mining Co.*, 240 U. S. 103, and *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, unless timberland differs in this particular from mines, which is denied in *Kauri Timber Company v. Commissioner of Taxes* (1913), A. C. 771, 778.

(b) Assuming that the matter is still open in this court, it appears impossible to say, on principle or authority, that the mere appreciation in value of timber is income at the time it occurs to a corporation whose purpose and actual business is to make profits out of the sale of lumber to which ultimate end the cutting of the timber is but one step. *Commissioners of Taxation v. Kirk* (1900), A. C. 588, 592. To allow this would require the same principle to be extended to the transportation of the logs to the mill and, in fine, to all the processes of manufacture up to the last moment of the sale to the consumer, in which case there would apparently be no income at all to anybody in the processes of production and distribution. In the present case the company claims the right to charge manufacturing cost with the value of the logs (although it, in fact, never kept its books in this way). (R. 45, 47.) If this be done, however, the log account should be credited with the same amount, and the profits

thereby shown in that account added to the manufacturing profits, in which case the same result would be reached as is claimed by the United States.

(c) As to the point that the conversion of the timber into lumber was a realization of "capital assets," and therefore did not produce income, little additional need be said. On no possible theory can the timber be called "capital assets." It was just as much "circulating" or "working" capital as the cut logs or the sawed lumber. Its whole destination, according to the charter of the company and its actual business carried on thereunder, was its conversion into salable lumber and the derivation of profits from such sale. Therefore, according to all the authorities the proceeds of sale of the lumber are income to their full extent irrespective of the part played therein by the conversion of the timber.

(d) The particular circumstances of this case argue strongly against the claim that conversion of "capital assets" does not produce income. Not only were the entire net proceeds of lumber sales carried to "profit and loss" and paid out as dividends or carried to surplus for dividends (R. 46, 109; Finding XXX-b), but it is admitted that, leaving entirely out of account appreciation of timber the allowance of which is now claimed by the respondent, the company on December 31, 1908, had surplus greater in value than its original invested capital (R. 66).

(e) The proceeds of sale of certain small parcels of land by the company are income on general prin-

ciples and under the terms of the Corporation Tax Act. Whatever may be the merit of the distinction between permanent and circulating capital, it is clear that where a corporation sells a portion of its assets no longer needed in its business, leaving sufficient other assets to cover its capital stock, this stamps those assets conclusively as "circulating" and their proceeds as "profits" which may be distributed in dividends. The matter will be further considered in the case of *C. C. C. & St. L. Railway Co.*, No. 593, where it is of final importance.

LYNCH V. HORNBY, No. 422.

This case requires merely a combination of the principles applicable to the Southern Pacific Company with those applicable to the Mitchell Brothers Company. The respondent, like the Southern Pacific Company, received dividends paid by a corporation in all respects similar to the Mitchell Brothers Company. As argued in regard to the latter, income was not received by the Cloquet Lumber Company until the lumber was sold, and such proceeds of sale were the "gross amount of the income" of such company. As in the case of the former, so as to Hornby, no income "accrued" until the "dividend" was paid to him, and that "dividend" was the "gross amount of his income." The fact that a portion of it came from the conversion of timber into lumber does not exclude that portion from income nor permit of its deduction.

LYNCH V. TURRISH, No. 421.

This case differs from the *Mitchell Brothers Company* and *Hornby* cases only in the fact that the company sold all its timberlands at one time and distributed the entire proceeds among its stockholders, thus practically winding up the venture. This fact, however, does not distinguish the case in law. It is not as though the company had been incorporated for the carrying on of a certain business or trade, and, finding this unprofitable, had voluntarily liquidated, returning to its stockholders their original capital. It was, like *Stratton's Independence, Limited*, and the *Sargent Land Company*, a company the aim of whose existence was dissolution. The purpose of its organization was to hold timberland and finally sell it as such at a profit. In other words, the timberland was its "working capital," and the services actually realized from it must be income. The case is therefore governed by the rule laid down, not in *Tebrau Rubber Syndicate v. Farmer*, 5 Tax Cas. 658, but in *Californian Syndicate v. Harris*, 5 Tax Cas. 159, to which the court's attention is especially directed. Furthermore, it appears to be entirely governed by the decision of this court in *Eyster v. Centennial Board of Finance*, 94 U. S. 500. There the board had been incorporated for the purpose of financing the Centennial Exposition at Philadelphia, and it was provided that after the exhibition had closed the corporation should convert its property into cash and, after

paying its debts, divide its assets among its stockholders. Subsequently Congress appropriated money to complete the buildings and provided that after the debts were paid the money should be paid back "before any dividend or percentage of profits shall be paid" to the stockholders. It was claimed that the return to the stockholders of the original amount subscribed would not be a "dividend of profits." It was held that, considering the purpose and end of the corporation, the distribution to the stockholders at the conclusion of its activities was a "dividend of profits." The court said (p. 505):

We think * * * that the word "profits" was used in 1876 to represent the net receipts of the business of the exhibition to be had in the buildings erected and upon the grounds prepared for its accommodation by means of the capital of the Centennial Board of Finance. *In this way "profits," in the act of 1876, and "remaining assets," in that of 1872, have substantially the same meaning; and the two statutes are relieved from all discrepancies, without doing violence to the language of either. [Italics ours.]*

It is submitted that as to the Payette Company, in which Turrish held stock, it is even truer that, owing to the purpose of the organization of the company, "profits" to its stockholders was equivalent to a division of its "remaining assets." If this be not true, the result is that persons or corporations engaged in the business of acquiring timberlands for resale at an advance will never have any income

taxable under these acts, because clearly the annual appreciation in the value of the lands can not be reached under their terms, and the final disposition of the lands and closing out of the speculation produces no income at that time, but is merely a realization of capital. Such a conclusion can not possibly be admitted, and yet it is a necessary inference from the decision of the court below.

UNITED STATES v. BIWABIK MINING Co., No. 594.

This case is governed by *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503. The latter would be on all fours were it not that the Biwabik Company was a *lessee* instead of a *lessor*. This, however, only makes the case worse for it, as was pointed out by Judge (now Justice) Clarke in the District Court (R. 15). The Supreme Court of Wisconsin has passed directly on the point in *Klar Piquette Mining Co. v. Platteville*, 163 Wis. 215, pointing out the evident fact that depreciation of the leasehold is already allowed for in deduction of the royalties paid. It might be added that in the present case, in so far as the record stands here, the company was allowed not only the royalties but a proportionate part of the premium paid for the lease (R. 16).

THE GOLDFIELD CONSOLIDATED MINES Co. v. SCOTT, No. 334.

(a) The first question certified must be answered in the negative on the authority of *Stratton's Independence, Limited, v. Howbert*, 231 U. S. 399.

(b) The second question is whether the original cost of the ore removed from a mine, figured on the

basis given in Treasury Regulation of February 14, 1911 (T. D. 1675), may be deducted under the Corporation Tax Act. This question must be likewise answered in the negative on the authority of *Anderson v. Forty-Two Broadway*, 239 U. S. 69. The only heading under which such a deduction can be brought is "expenses actually paid *within the year*" which evidently is not broad enough. The difficulty lies in the fact that Congress fixed "the calendar year" as the controlling period as to both receipts and expenses. This artificial period does not, of course, correspond to the actual facts of business in many cases. The matter, however, was understood by Congress as is shown by the debate between Senators Williams and Cummins when the act of October 3, 1913, was on its passage (50 Cong. Rec., pp. 3775, 3776). The remedy lies with that body, which has attempted to cure the evil as to mines and as to sales of property generally.

(c) It therefore becomes unnecessary to return any answer to the third and fourth questions. It is not supposed that any claim of estoppel against the Government is involved in them, for of course no such claim could possibly be sustained.

Group III.

UNITED STATES v. THE CLEVELAND, CINCINNATI, CHICAGO & ST. LOUIS RY. CO., No. 593.

(a) This case presents the simple question whether the proceeds of sale of shares of stock in one railroad company acquired by another railroad company

prior to the passage of the Corporation Excise Tax Act, but sold after that time, are income within the meaning of that act. It is claimed that the case of *Gray v. Darlington*, 15 Wall. 63, is controlling. It is clear, however, as has already been argued, that the case is not an authority because of the entirely different language of the act there under consideration, which was made the basis for the decision. Even if it can be claimed that the case really decides that the proceeds of sale of "investments" is not, and can not in its nature be, "income," since it is merely "capital" in another form, there are two reasons why we think it should not control the present case.

(1) The reasoning of the court is not persuasive. There appear to be unconscious gaps in it. It is stated on page 65 of the opinion that the advance in the value of property during a series of years can not be considered income of any one year. From this it is inferred that *the sale* of the property can not produce income, although this conclusion seems to have no connection with the premise. Again on page 66 it is stated that mere advance in value does not constitute income, but here the reference to a sale is omitted, and it is assumed that the Government was attempting to tax this mere increase in value and not (as was the fact) the proceeds of sale. No distinction is made in the opinion between the proceeds of sale of one kind of property and another, so that according to the principle laid down any property purchased in one year and sold in another would fall within the ruling.

This was perceived and an exception was made of the "stock" of a trader and merchant, but the only reason given for the exception is that the successful prosecution of such a business requires property to be held over a year. It is not unlikely, as has been stated above, that the court had in mind the distinction between property held by its owner for permanent investment and property held for the profit expected from a sale; but, if so, the distinction is not clearly stated nor the reasons justifying it (if any) explained.

(2) Even if the case of *Gray v. Darlington* be taken to lay down a rule that, under the circumstances there disclosed, a conversion of "permanent capital" did not produce income at all, and even if that rule be considered sound by this court, it does not apply to the case of a corporation acquiring assets as incidental to the purposes of its general business and subsequently disposing of them because they are no longer needed for such business. A corporation might, it is true, be incorporated merely for the purpose of holding investments, receiving the dividends, interest, or rentals therefrom, and changing the investments from time to time for new ones of the same character. Such were the corporations before this court in *Zonne v. Minneapolis Syndicate*, 220 U. S. 187, and *United States v. Emery, Bird, Thayer Realty Co.*, 237 U. S. 28. The railway company in the present case, however, was not a corporation of this character, but was engaged in an active business to which the acquisition and holding of the shares in question

was merely incidental. When, therefore, it determined that the shares were no longer necessary for the purposes of that business, and when it accordingly disposed of them, leaving the capital required for the carrying on of its chartered business or trade intact, the proceeds of sale were, by its own action, stamped with the character of income, and were legally available for distribution as profits, in the same manner as would have been the proceeds of sale of worn-out engines or rails. There was no obligation on the company to reinvest the proceeds in other shares of stock, as would have been the case had it been incorporated merely for the purpose of holding investments. The company itself perceived this, and accordingly credited the proceeds of the sale of these shares to "profit and loss" (R. 12).

The distinction here made between the situation, under the Corporation Tax Act, of a corporation purchasing assets as incidental to its regular business and that of an individual investor under the Civil War income tax acts is sustained on principle by the decision of this court in *Flint v. Stone-Tracy Co.*, 220 U. S. 107, 162, 165, 171. It was there held in effect that the income from investments held by active corporations as incidental to their business was taxable under the Corporation Tax Act, and there is nothing in the opinion to indicate that this court meant to exclude from this liability the proceeds of sale of such assets made because the company in question had no further use for them in its business. (And see *Von Baumbach v. Sargent Land Co.*, 242

U. S. 503, 516.) We claim, therefore, that giving the decision in *Gray v. Darlington* the widest effect which can be claimed for it, it is inapplicable to the cases at bar.

HAYS V. THE GAULEY MOUNTAIN COAL CO., No. 327.

This case can not be distinguished in any respect from that of the Railway Company, and it is not necessary, therefore, to say anything additional concerning it.

CONCLUSION.

In the case of the *Southern Pacific Company v. Lowe*, No. 452, the judgment of the court below should be affirmed.

In the case of *Peabody v. Eisner*, No. 705, the judgment of the court below should be affirmed.

In the case of *Doyle v. Mitchell Brothers Company*, No. 492, the judgment of the Circuit Court of Appeals should be reversed and judgment should be entered for the defendant.

In *Lynch v. Hornby*, No. 422, the judgment of the Circuit Court of Appeals should be reversed and judgment should be entered for the defendant.

In *Lynch v. Turrish*, No. 421, the judgment of the Circuit Court of Appeals should be reversed and judgment entered for the defendant.

In the case of the *United States of America v. Biwabik Mining Company*, No. 594, the judgment of the Circuit Court of Appeals should be reversed and the judgment of the District Court affirmed.

In *Goldfield Consolidated Mines Company v. Scott* the first and second questions certified should be answered in the negative, which renders unnecessary any answer to the third and fourth questions.

In *United States of America v. The Cleveland, Cincinnati, Chicago & St. Louis Railway Company*, No. 593, the judgment of the Circuit Court of Appeal, should be reversed and the judgment of the District Court affirmed.

In *Hays v. The Gauley Mountain Coal Company*, No. 327, the judgment of the Circuit Court of Appeals should be reversed and the judgment of the District Court affirmed.

JOHN W. DAVIS,
Solicitor General.

WM. C. HERRON,
Attorney.

FEBRUARY, 1918.

42314-18-7

in the case of the United States v. ...
the first and second questions ...
answer in the negative, which ...
any answer to the third and fourth questions.

in the case of the United States v. ...
United States v. ...
the judgment of the Circuit Court of appeals
should be reversed and the judgment of the District
Court affirmed.

in the case of the United States v. ...
the judgment of the District Court of appeals
should be reversed and the judgment of the District
Court affirmed.

John W. Davis
Attorney General
Wm. C. Herrick
Attorney General

in the case of the United States v. ...
the judgment of the District Court of appeals
should be reversed and the judgment of the District
Court affirmed.

in the case of the United States v. ...
the judgment of the District Court of appeals
should be reversed and the judgment of the District
Court affirmed.

in the case of the United States v. ...
the judgment of the District Court of appeals
should be reversed and the judgment of the District
Court affirmed.

in the case of the United States v. ...
the judgment of the District Court of appeals
should be reversed and the judgment of the District
Court affirmed.

APPENDIX A.

CORPORATION TAX ACT.

[August 5, 1909, 36 Stat. 11, 112.]

SEC. 38. That every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any State or Territory of the United States or under the acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any State or Territory of the United States or in Alaska or in the District of Columbia, shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, *equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year*, exclusive of amounts received by it as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed; or if organized under the laws of any foreign country, upon the amount of net income over and above five thousand dollars received by it from business transacted and capital invested within the United States and its Territories, Alaska, and the District of Columbia during such year, exclusive of amounts so received by it as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed: *Provided, however, That nothing in this*

section contained shall apply to labor, agricultural or horticultural organizations, or to fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders or associations, and dependents of such members, nor to domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members, nor to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.

Second. Such net income shall be ascertained by deducting from *the gross amount of the income* of such corporation, joint stock company or association, or insurance company, *received within the year from all sources*, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, all interest actually paid by it within the year on deposits; (fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country as a condition to carrying on business therein; (fifth) all amounts received by it within the year as divi-

dends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed: *Provided*, That in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, such net income shall be ascertained by deducting from *the gross amount of its income received within the year* from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia, (first) all the ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business and property within the United States and its Territories, Alaska, and the District of Columbia, including all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year in business conducted by it within the United States or its Territories, Alaska, or the District of Columbia not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness, not exceeding the proportion of its paid-up capital stock outstanding at the close of the year which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia bears to the *gross amount of its income derived from all sources within and without the United States*; (fourth) the sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof; (fifth) all amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, and insurance companies, subject to the tax hereby imposed. In the case of assessment insurance companies the actual deposit of sums with State or Terri-

torial officers, pursuant to law, as additions to guaranty or reserve funds shall be treated as being payments required by law to reserve funds.

Third. There shall be deducted from the amount of the net income of each of such corporations, joint stock companies or associations, or insurance companies, ascertained as provided in the foregoing paragraphs of this section, the sum of five thousand dollars, and said tax shall be computed upon the remainder of said net income of such corporation, joint stock company or association, or insurance company, for the year ending December thirty-first, nineteen hundred and nine, and for each calendar year thereafter; and on or before the first day of March, nineteen hundred and ten, and the first day of March in each year thereafter, a true and accurate return under oath or affirmation of its president, vice-president, or other principal officer, and its treasurer or assistant treasurer, shall be made by each of the corporations, joint stock companies or associations, and insurance companies, subject to the tax imposed by this section, to the collector of internal revenue for the district in which such corporation, joint stock company or association, or insurance company, has its principal place of business, or, in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, in the place where its principal business is carried on within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, setting forth, (first) the total amount of the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year; (second) the total amount of the bonded and other indebtedness of such corporation, joint stock company or association, or insurance company at the close of the year; (third) the gross amount of the income of such corporation, joint stock company or association, or insurance company, received during each year from all sources, and if organized under the laws of a foreign country the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia;

also the amount received by such corporation, joint stock company or association, or insurance company, within the year by way of dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed by this section; (fourth) the total amount of all the ordinary and necessary expenses actually paid out of earnings in the maintenance and operation of the business and properties of such corporation, joint stock company or association, or insurance company, within the year, stating separately all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property, and if organized under the laws of a foreign country the amount so paid in the maintenance and operation of its business within the United States and its Territories, Alaska, and the District of Columbia; (fifth) the total amount of all losses actually sustained during the year and not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; and in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, all losses actually sustained by it during the year in business conducted by it within the United States or its Territories, Alaska, and the District of Columbia, not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve fund; (sixth) the amount of interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, stating separately all interest paid by it

within the year on deposits; or in case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia, bears to the gross amount of its income derived from all sources within and without the United States; (seventh) the amount paid by it within the year for taxes imposed under the authority of the United States or any State or Territory thereof, and separately the amount so paid by it for taxes imposed by the government of any foreign country as a condition to carrying on business therein; (eighth) the net income of such corporation, joint stock company or association, or insurance company, after making the deductions in this section authorized. All such returns shall as received be transmitted forthwith by the collector to the Commissioner of Internal Revenue.¹

¹ Remaining sections are administrative in character and immaterial for present purposes.

APPENDIX B.

INCOME TAX ACT.

[Section 2, act October 3, 1913, 38 Stat. 114, 166.]

A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon *the entire net income arising or accruing from all sources* in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid annually upon the *entire net income from all property owned* and of every business, trade, or profession carried on in the *United States* by persons residing elsewhere.

Subdivision 2. In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum upon the amount by which the total net income exceeds \$20,000 and does not exceed \$50,000, and 2 per centum per annum upon the amount by which the total net income exceeds \$50,000 and does not exceed \$75,000, 3 per centum per annum upon the amount by which the total net income exceeds \$75,000 and does not exceed \$100,000, 4 per centum per annum upon the amount by which the total net income exceeds \$100,000 and does not exceed \$250,000, 5 per centum per annum upon the amount by which the total net

income exceeds \$250,000 and does not exceed \$500,000, and 6 per centum per annum upon the amount by which the total net income exceeds \$500,000. All the provisions of this section relating to individuals who are chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of paragraph A, shall apply to the levy, assessment, and collection of the additional tax imposed under this section. Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his *total net income from all sources, corporate or otherwise*, for the preceding calendar year, under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury. For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be *prima facie* evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same if distributed.

B. That, subject only to such exemptions and deductions as are hereinafter allowed, *the net income of a taxable person shall include gains, profits, and income derived from*

salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent: Provided, That the proceeds of life insurance policies paid upon the death of the person insured or payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income.

That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due to the taxpayer actually ascertained to be worthless and charged off within the year; sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made: *Provided, That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate; seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, asso-*

ciation, or insurance company which is taxable upon its net income as hereinafter provided; eighth, the amount of income, the tax upon which has been paid or withheld for payment at the source of the income, under the provisions of this section, provided that whenever the tax upon the income of a person is required to be withheld and paid at the source as hereinafter required, if such annual income does not exceed the sum of \$3,000 or is not fixed or certain, or is indefinite, or irregular as to amount or time of accrual, the same shall not be deducted in the personal return of such person.

The net income from property owned and business carried on in the United States by persons residing elsewhere shall be computed upon the basis prescribed in this paragraph and that part of paragraph G of this section relating to the computation of the net income of corporations, joint-stock and insurance companies, organized, created, or existing under the laws of foreign countries, in so far as applicable.

That in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions; also the compensation of the present President of the United States during the term for which he has been elected, and of the judges of the supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a State or any political subdivision thereof except when such compensation is paid by the United States Government.

C. That there shall be deducted from the amount of the net income of each of said persons, ascertained as provided herein, the sum of \$3,000, plus \$1,000 additional if the person making the return be a married man with a wife living with him, or plus the sum of \$1,000 additional if the person making the return be a married woman with a husband living with her; but in no event shall this additional exemption of \$1,000 be deducted by both a husband and a wife: *Provided*, That only one deduction of \$4,000 shall be made from the aggregate income of both husband and wife when living together.

D. The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding calendar year ending December thirty-first: *Provided, however,* That for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive, after deducting five-sixths only of the specific exemptions and deductions herein provided for. On or before the first day of March, nineteen hundred and fourteen, and the first day of March in each year thereafter, a true and accurate return, under oath or affirmation, shall be made by each person of lawful age, except as hereinafter provided, subject to the tax imposed by this section, and having a net income of \$3,000 or over for the taxable year, to the collector of internal revenue for the district in which such person resides or has his principal place of business, or, in the case of a person residing in a foreign country, in the place where his principal business is carried on within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, setting forth specifically *the gross amount of income from all separate sources and from the total thereof, deducting the aggregate items or expenses and allowance herein authorized;* guardians, trustees, executors, administrators, agents, receivers, conservators, and all persons, corporations, or associations acting in any fiduciary capacity, shall make and render a return of the net income of the person for whom they act, subject to this tax, coming into their custody or control and management, and be subject to all the provisions of this section which apply to individuals: *Provided,* That a return made by one of two or more joint guardians, trustees, executors, administrators, agents, receivers, and conservators, or other persons acting in a fiduciary capacity, filed in the district where such person resides, or in the district where the will or other instrument under which he acts is recorded, under such regulations as the Secretary of the Treasury may prescribe, shall be a sufficient compliance with the requirements of this paragraph; and also all persons, firms, companies, copartnerships, corporations, joint-stock companies or asso-

ciations, and insurance companies, except as hereinafter provided, in whatever capacity acting, having the control, receipt, disposal, or payment of fixed or determinable annual or periodical gains, profits, and income of another person subject to tax, shall in behalf of such person deduct and withhold from the payment an amount equivalent to the normal income tax upon the same and make and render a return, as aforesaid, but separate and distinct, of the portion of the income of each person from which the normal tax has been thus withheld, and containing also the name and address of such person or stating that the name and address or the address, as the case may be, are unknown: *Provided*, That the provision requiring the normal tax of individuals to be withheld at the source of the income shall not be construed to require any of such tax to be withheld prior to the first day of November, nineteen hundred and thirteen: *Provided further*, That in either case above mentioned no return of income not exceeding \$3,000 shall be required: *Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section, and any such firm, when requested by the Commissioner of Internal Revenue, or any district collector, shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same, if distributed: *Provided further*, That persons liable for the normal income tax only, on their own account or in behalf of another, shall not be required to make return of the income derived from dividends on the capital stock or from the net earnings of corporations, joint-stock companies or associations, and insurance companies taxable upon their net income as hereinafter provided. Any person for whom return has been made and the tax paid, or to be paid as aforesaid, shall not be required to make a return unless such person has other net income, but only one deduction of \$3,000 shall be made in the case of any such person. The collector or deputy collector shall require every list to be verified by the oath or affirmation of the party rendering it.

If the collector or deputy collector have reason to believe that the amount of any income returned is understated, he shall give due notice to the person making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated may increase the same accordingly. If dissatisfied with the decision of the collector, such person may submit the case, with all the papers, to the Commissioner of Internal Revenue for his decision, and may furnish sworn testimony of witnesses to prove any relevant facts.

E. [Withholding at the source.]

* * * * *

The tax herein imposed upon annual gains, profits, and income not falling under the foregoing and not returned and paid by virtue of the foregoing shall be assessed by personal return under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury.

The provisions of this section relating to the deduction and payment of the tax at the source of income shall only apply to the normal tax hereinbefore imposed upon individuals.

F. [Penalty for failure to make returns.]

G. (a) That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the *entire net income arising or accruing from all sources* during the preceding calendar year to every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships; but if organized, authorized, or existing under the laws of any foreign country, then upon the amount of *net income accruing from business transacted and capital invested within the United States during such year*: *Provided, however, That nothing in this section shall apply to labor, agricultural, or horticultural organizations, or to mutual savings banks not having a capital stock represented by shares, or to fraternal beneficiary societies, orders, or associations operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and providing for the payment of life, sick, accident, and other*

benefits to the members of such societies, orders, or associations and dependents of such members, nor to domestic building and loan associations, nor to cemetery companies, organized and operated exclusively for the mutual benefit of their members, nor to any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual, nor to business leagues, nor to chambers of commerce or boards of trade, not organized for profit or no part of the net income of which inures to the benefit of the private stockholder or individual; nor to any civic league or organization not organized for profit, but operated exclusively for the promotion of social welfare: *Provided further*, That there shall not be taxed under this section any *income derived* from any public utility or from the exercise of any essential governmental function accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State, Territory, or the District of Columbia, nor any income accruing to the government of the Philippine Islands or Porto Rico, or of any political subdivision of the Philippine Islands or Porto Rico: *Provided*, That whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, has, prior to the passage of this Act, entered in good faith into a contract with any person or corporation, the object and purpose of which is to acquire, construct, operate or maintain a public utility, no tax shall be levied under the provisions of this Act upon the *income derived* from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, or the District of Columbia, or a political subdivision of a State or Territory; but this provision is not intended to confer upon such person or corporation any financial gain or exemption or to relieve such person or corporation from the payment of a tax as provided for in this section upon the part or portion of the said income to which such person or corporation shall be entitled under such contract.

(b) Such net income shall be ascertained by deducting from the *gross amount of the income* of such corporation, joint-stock company or association, or insurance company,

received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made; and in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: Provided, That mutual fire insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: Provided further, That mutual marine insurance companies shall include in their return of gross income gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between the ascertainment thereof and the payment thereof and life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year; (third) the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of its interest bearing indebtedness and its paid-up capital stock outstanding at the close of the year,

or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year: *Provided*, That in case of indebtedness wholly secured by collateral the subject of sale in ordinary business of such corporation, joint-stock company, or association, the total interest secured and paid by such company, corporation, or association within the year on any such indebtedness may be deducted as a part of its expense of doing business: *Provided further*, That in the case of bonds or other indebtedness, which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed shall be allowed; and in the case of a bank, banking association, loan, or trust company, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company; (fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the Government of any foreign country: *Provided*, That in the case of a corporation, joint-stock company or association, or insurance company, organized, authorized, or existing under the laws of any foreign country, such net income shall be ascertained by deducting from *the gross amount of its income accrued within the year from business transacted and capital invested* within the United States, (first) all the ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business and property within the United States, including rentals or other payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year in business conducted by it within the United States and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any, and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made; and in case of insurance com-

panies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: *Provided further*, That mutual fire insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income *all income received by them from all other sources* plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: *Provided further*, That mutual marine insurance companies shall include in their return of *gross income* gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment thereof and the payment thereof and life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year; (third) the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding the proportion of one-half of the sum of its interest bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the capital employed in the business at the close of the year which the *gross amount of its income* for the year from business transacted and capital invested within the United States bears to the *gross amount of its income* derived from all sources within and without the United States: *Provided*, That in the case of bonds or other indebtedness which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed shall be allowed; (fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof or the District of Columbia. In the case of assess-

ment insurance companies, whether domestic or foreign, the actual deposit of sums with State or Territorial officers, pursuant to law, as additions to guarantee or reserve funds shall be treated as being payments required by law to reserve funds.

(c) The tax herein imposed shall be computed upon its *entire net income accrued* within each preceding calendar year ending December thirty-first: *Provided, however*, That for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be imposed upon its *entire net income accrued* within that portion of said year from March first to December thirty-first, both dates inclusive, to be ascertained by taking five-sixths of its entire net income for said calendar year: *Provided further*, That any corporation, joint-stock company or association, or insurance company subject to this tax may designate the last day of any month in the year as the day of the closing of its fiscal year and shall be entitled to have the tax payable by it computed upon the basis of the net income ascertained as herein provided for the year ending on the day so designated in the year preceding the date of assessment instead of upon the basis of the net income for the calendar year preceding the date of assessment; and it shall give notice of the day it has thus designated as the closing of its fiscal year to the collector of the district in which its principal business office is located at any time not less than thirty days prior to the date upon which its annual return shall be filed. All corporations, joint-stock companies or associations, and insurance companies subject to the tax herein imposed, computing taxes upon the income of the calendar year, shall, on or before the first day of March, nineteen hundred and fourteen, and the first day of March in each year thereafter, and all corporations, joint-stock companies or associations, and insurance companies, computing taxes upon the income of a fiscal year which it may designate in the manner hereinbefore provided, shall render a like return within sixty days after the close of its said fiscal year, and within sixty days after the close of its fiscal year in each year thereafter, or in the case of a corporation, joint-stock company or association, or insurance company, organized or existing under the laws of a foreign country, in the place where its princi-

pal business is located within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, shall render a true and accurate return under oath or affirmation of its president, vice president, or other principal officer, and its treasurer or assistant treasurer, to the collector of internal revenue for the district in which it has its principal place of business, setting forth *(first)* the total amount of its paid-up capital stock outstanding, or if no capital stock, its capital employed in business, at the close of the year; *(second)* the total amount of its bonded and other indebtedness at the close of the year; *(third)* the gross amount of its income, received during such year from all sources, and if organized under the laws of a foreign country the gross amount of its income received within the year from business transacted and capital invested within the United States; *(fourth)* the total amount of all its ordinary and necessary expenses paid out of earnings in the maintenance and operation of the business and properties of such corporation, joint-stock company or association, or insurance company within the year, stating separately all rentals or other payments required to be made as a condition to the continued use or possession of property, and if organized under the laws of a foreign country the amount so paid in the maintenance and operation of its business within the United States; *(fifth)* the total amount of all losses actually sustained during the year and not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: *Provided further*, That mutual fire insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: *Provided further*, That mutual marine insurance companies

shall include in their *return of gross income* gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment thereof and the payment thereof and life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year; and in case of a corporation, joint-stock company or association, or insurance company, organized under the laws of a foreign country, all losses actually sustained by it during the year in business conducted by it within the United States, not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: *Provided further*, That mutual fire insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: *Provided further*, That mutual marine insurance companies shall include in their *return of gross income* gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between the ascertainment thereof and the payment thereof and life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abate-

ment of premium of such individual policyholder, within such year; (*sixth*) the amount of interest accrued and paid within the year on its bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock, outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of indebtedness not exceeding the amount of capital employed in the business at the close of the year, and in the case of a bank, banking association, or trust company, stating separately all interest paid by it within the year on deposits; or in case of a corporation, joint-stock company or association, or insurance company, organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of capital employed in the business at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income derived from all sources within and without the United States; (*seventh*) the amount paid by it within the year for taxes imposed under the authority of the United States and separately the amount so paid by it for taxes imposed by the Government of any foreign country; (*eighth*) *the net income* of such corporation, joint-stock company or association, or insurance company, *after making the deductions in this subsection authorized*. All such returns shall as received be transmitted forthwith by the collector to the Commissioner of Internal Revenue.

All assessments shall be made and the several corporations, joint-stock companies or associations, and insurance companies shall be notified of the amount for which they are respectively liable on or before the first day of June of each successive year, and said assessment shall be paid on or before the thirtieth day of June: *Provided*, That every corporation, joint-stock company or association, and insurance company, computing taxes upon the income of the fiscal year which it may designate in the manner hereinbefore

provided, shall pay the taxes due under its assessment within one hundred and twenty days after the date upon which it is required to file its list or return of income for assessment; except in cases of refusal or neglect to make such return, and in cases of false or fraudulent returns, in which case, the Commissioner of Internal Revenue shall, upon the discovery thereof, at any time within three years after said return is due, make a return upon information obtained as provided for in this section or by existing law, and the assessment made by the Commissioner of Internal Revenue thereon shall be paid by such corporation, joint-stock company or association, or insurance company immediately upon notification of the amount of such assessment; and to any sum or sums due and unpaid after the thirtieth day of June in any year, or after one hundred and twenty days from the date on which the return of income is required to be made by the taxpayer, and after ten days notice and demand thereof by the collector, there shall be added the sum of 5 per centum on the amount of tax unpaid and interest at the rate of 1 per centum per month upon said tax from the time the same becomes due.

(d) When the assessment shall be made, as provided in this section, the returns, together with any corrections thereof which may have been made by the commissioner, shall be filed in the office of the Commissioner of Internal Revenue and shall constitute public records and be open to inspection as such: *Provided*, That any and all such returns shall be open to inspection only upon the order of the President, under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President: *Provided further*, That the proper officers of any State imposing a general income tax may, upon the request of the governor thereof, have access to said returns or to an abstract thereof, showing the name and income of each such corporation, joint-stock company, association or insurance company, at such times and in such manner as the Secretary of the Treasury may prescribe.

If any of the corporations, joint-stock companies or associations, or insurance companies aforesaid, shall refuse or neglect to make a return at the time or times hereinbefore

specified in each year, or shall render a false or fraudulent return, such corporation, joint-stock company or association, or insurance company shall be liable to a penalty of not exceeding \$10,000.

H. That the word "State" or "United States" when used in this section shall be construed to include any Territory, Alaska, the District of Columbia, Porto Rico, and the Philippine Islands, when such construction is necessary to carry out its provisions.

C

FEB 7 1918

JAMES D. MAHER,
CLERK

Supreme Court of the United States

OCTOBER TERM, 1917

No. 452

SOUTHERN PACIFIC COMPANY,
Plaintiff in Error,

against

JOHN Z. LOWE, JR., United States Collector of Internal
Revenue for the Second District of New York.

BRIEF FOR PLAINTIFF IN ERROR

GORDON M. BUCK,
Counsel for Plaintiff in Error,
165 Broadway,
New York, N. Y.



INDEX.

	PAGE
Statement of Facts.....	1
Proof of Facts.....	4
Sufficiency of Proof.....	13
Specification of Errors.....	25
Argument	26
I. Jurisdiction	26
II. The Act should not be construed as imposing a tax on dividends paid from a surplus accumulated prior to the Sixteenth Amendment.....	27
(1) Statutes imposing taxes must be strictly con- strued against the Government and in favor of the taxpayer	28
(2) Analysis of the Act.....	29
(a) Not all "income," in the sense of everything that comes in, is taxed, but only income that consists of gains or profits	31
(b) It is not enough that gains or profits were received within the year, but they must have been gains or profits "arising or accruing" during such year	39
(c) The Act specifically limits the income to be taxed to that accruing on and after March 1, 1913.....	42
(d) It is significant that the Act makes a distinction between dividends and the income derived from dividends or from the net earnings of corpora- tions	43
(e) The Act recognizes that a stockholder is the owner of his <i>pro rata</i> share of the corporate surplus before it is distributed in the shape of dividends	44
(f) The Act requires an individual to pay an "additional tax" on dividends where his income exceeds a pre- scribed amount, thus implying that the tax is supplemental to another and prior tax. But the individual pays no normal tax on dividends,	

	PAGE
and the corporation pays no income tax on surplus earned by it prior to March 1, 1913. Hence, in the case of dividends from such surplus, to what would the "additional tax" be an addition?	46
(3) That dividends from a surplus accrued prior to the Sixteenth Amendment are not taxable under the Act has several times been decided by the courts.....	47
(4) Statutes in <i>pari materia</i> and decisions thereunder	53
(5) As between life tenant and remainderman, an extraordinary cash dividend constitutes capital, if paid from surplus accruing prior to the establishment of the trust.....	66
III. The Act should be so construed as to avoid raising any question as to its constitutionality.....	77
IV. The Act is unconstitutional if construed as imposing a tax on dividends paid to one corporation by another out of a surplus that accrued prior to the Sixteenth Amendment	78
V. Inequality and hardship result from the Treasury Department's construction of the law.....	92
(1) The spirit of the Act as a tax on net income should prevail	94
(2) A construction producing inequality and hardship should be avoided.....	95
(3) Moreover, a construction producing inequality and hardship would render the Act unconstitutional	96
VI. Unity of Southern Pacific System and consequent possession and control by the plaintiff of the funds from which the dividends in question were paid long prior to their declaration	98
VII. Dividends paid from the sale of capital assets do not constitute income	102
VIII. Reply to the defendant's contentions in lower court.....	105
IX. The plaintiff has taken the proper steps to recover the tax in controversy.....	112
X. Conclusion	114

TABLE OF CASES.

	PAGE
Altman, B., & Co. v. U. S., 224 U. S., 583.....	26
American Surety Company v. Pauly, 72 Fed., 470, 478 (C. C. A.); 170 U. S., 133, 159.....	24
Anderson v. Richards' Executors, 99 Ky., 661.....	40
Assets Company v. Forbes, 3 Tax Cas., 542.....	105
Atchison, &c., Ry. Co. v. O'Connor, 223 U. S., 280.....	114
Bailey v. R. Co., 22 Wall., 604; 106 U. S., 109, 37, 54, 74, 76, 100, 115	115
Baldwin Locomotive Works v. McCoach, 221 Fed., 59 (C. C. A.).....	33, 103, 107
Ballantine v. Young, 79 N. J. Eq., 70, 73.....	68
Bates v. Preble, 151 U. S., 149, 155.....	24
Beuttell v. Magone, 157 U. S., 154, 157.....	27
Bishop v. Bishop, 81 Conn., 509.....	68
Bridgeport Trust Co. v. Marsh, 87 Conn., 384, 398.....	41
Brownell v. Anthony, 189 Mass., 442.....	44
Brushaber v. R. Co., 240 U. S., 1, 18.....	26, 79, 81, 97
Cambria Steel Co. v. McCoach, 225 Fed., 278.....	114
Carey v. R. Co., 150 U. S., 170.....	26
Carley v. Mfg. Co., 81 N. J. L., 502, 508.....	41
Chesapeake & Ohio Railway Co. v. Stojanowski, 191 Fed., 720	23
City of St. Joseph, 205 Fed., 284 (C. C. A.).....	24
Cobb v. Fant, 36 S. C., 1.....	69
Collector v. Hubbard, 12 Wall., 1, 17.....	36, 45, 49, 100
Continental Bank v. First National Bank, 108 Tenn., 374, 380..	24
Curtis v. Osborn, 79 Conn., 555, 562.....	44
Dodge v. Brady, 240 U. S., 122.....	113
Doyle v. Mitchell, 235 Fed., 686 (C. C. A.).....	33, 66, 103
Earp's Appeal, 28 Pa. St., 368.....	68
Edwards v. Keith, 231 Fed., 110; 243 U. S., 638.....	88
Eidman v. Martinez, 184 U. S., 578, 583.....	28
Eisner's Appeal, 175 Pa. St., 143.....	104
Empire State Cattle Company v. R. Co., 210 U. S., 1, 8.....	27
Ercanbrack v. Faris, 10 Idaho, 584.....	41
Eyster v. Centennial Board, 94 U. S., 500.....	107
Feuchtwanger v. Malting Co., 187 Fed., 713, 717 (C. C. A.)..	24
Flint v. Stone Tracy Co., 220 U. S., 107, 162.....	91
Gaar, Scott & Co. v. Shannon, 223 U. S., 468.....	114
G., H. & S. A. Ry. Co. v. Texas, 210 U. S., 217, 227.....	83
Gauley Mountain Coal Co. v. Hays, 230 Fed., 110 (C. C. A.).....	33, 103
Gibbons v. Mahon, 136 U. S., 549, 559.....	74
Gifford v. Thompson, 115 Mass., 478.....	44
Gilkey v. Paine, 80 Me., 319.....	69
Goodwin v. McGaughey, 108 Minn., 248, 256.....	69

	PAGE
Gould v. Gould, U. S. Sup. Ct., Nov. 19, 1917.....	28
Graham's Estate, 198 Pa. St., 216, 222.....	104
Gray v. Darlington, 15 Wall., 63.....	33, 63
Grunberg v. U. S., 145 Fed., 81, 95 (C. C. A.).....	24
Gulf Oil Corporation v. Lewellyn, Collector, 242 Fed., 709.....	31, 51
Harriman v. I. C. C., 211 U. S., 407, 423.....	77
Harteau, Matter of, 204 N. Y., 292.....	68
Heard v. Eldredge, 109 Mass., 258.....	72, 104
Heike v. U. S., 192 Fed., 83, 95 (C. C. A.).....	24
Hitchner Wall Paper Co. v. R. Co., 158 Fed., 1011, 1014.....	22
Holbrook v. Holbrook, 74 N. H., 201.....	68, 104
Horner v. U. S., No. 2, 143 U. S., 570.....	26
Hudson Bay Co. v. Stevens, 5 Tax Cas., 424.....	105
Industrial Trust Co. v. Walsh, 222 Fed., 437, 443.....	33, 103, 107
Insurance Co. v. Weide, 9 Wall., 677, 680.....	24
Johnson v. Mfg. Co., 80 Mass., 274.....	72, 73
Kalbach v. Clark, 133 Iowa, 215, 220.....	104
King v. Loxdale, 1 Burr., 445.....	52
Knights Templar & Indemnity Co. v. Jarman, 187 U. S., 197, 205.....	77
Knowlton v. Moore, 178 U. S., 41, 77.....	95
Lang v. Lang's Executor, 57 N. J. Eq., 325.....	68, 71
Lawless v. Sullivan, L. R., 6 App. Cas., 373.....	33
Lewellyn v. Gulf Oil Co., 245 Fed., 1 (C. C. A.).....	51
Leland v. Hayden, 102 Mass., 542, 550.....	72
Leman v. Chipman, 82 Nebr., 392, 396.....	41
Linn, &c., Co. v. U. S., 196 Fed., 593 (C. C. A.).....	101
London, etc., Bank, <i>in re</i> , 72 L. T., 227, affirmed 2 Ch., 166.....	107
Lord v. Brooks, 52 N. H., 72.....	68
Louisville & Nashville R. Co. v. Daniel, 123 Ky., 256, 265.....	23
Lynch v. Hornby, 236 Fed., 661 (C. C. A.).....	31, 38, 50, 100
Lynch v. Turrish, 236 Fed., 653, 656 (C. C. A.).....	31, 37, 38, 48, 100, 102
Mercer v. Buchanan, 132 Fed., 501; 137 Fed., 1019 (C. C. A.).....	76, 104
Merchants Ins. Co. v. McCartney, 1 Lowell, 447; Fed. Cas. No. 9,443.....	38, 61
Mifflin's Estate, 232 Pa. St., 25.....	41
Miller v. Payne, 150 Wis., 354 (1912).....	68, 103, 107
Minot v. Paine, 99 Mass., 101 (1868).....	72
Mississippi River Logging Co. v. Robson, 69 Fed., 773, 781 (C. C. A.).....	2
Northern Pacific Ry. Co. v. Keyes, 91 Fed., 47, 58.....	20
Northern Securities Co. v. U. S., 193 U. S., 197.....	101
Osborne, Matter of, 209 N. Y., 450, 474 (1913).....	68, 69
Peabody v. Eisner, U. S. Dist. Ct., Southern Dist. of N. Y. (unreported).....	51

INDEX.

v

	PAGE
Peirce v. Burroughs, 58 N. H., 302.....	68
Penn Mutual Life Ins. Co. v. Austin, 168 U. S., 635.....	26
People v. Davenport, 30 Hun, 177, 186.....	33
Pollock v. Trust Co., 157 U. S., 429.....	73, 78, 91, 97
Pollock v. Trust Co., 158 U. S., 601.....	76, 78, 90
Railroad Company v. Jackson, 7 Wall. (74 U. S.), 262.....	63
Reyburn v. Savings Bank, 171 Fed., 609 (C. C. A.).....	24
Reynolds v. M'Arthur, 2 Pet., 417, 434.....	80
Reynolds v. Williams, 4 Biss., 108; Fed. Cas. No. 11,734.38, 59, 100	104
Rogers, Matter of, 161 N. Y., 108.....	20
Rowland v. R. Co., 244 U. S., 106.....	69
Rutledge, <i>Ex parte</i> , 1 Harp., 65.....	24
St. Joseph, City of, 205 Fed., 284 (C. C. A.).....	98
San Mateo County v. R. Co., 13 Fed., 145, 150.....	44, 68
Second, etc., Church v. Colegrove, 74 Conn., 79.....	27
Sena v. American Turquoise Company, 220 U. S., 497, 501.....	80
Shreveport v. Cole, 129 U. S., 36, 43.....	101
Smith v. Moore, 199 Fed., 689 (C. C. A.).....	96
Society for Savings v. Coite, 6 Wall., 594, 609.....	68
Soehnlein v. Soehnlein, 146 Wis., 330, 340.....	98
Southern Ry. Co. v. Greene, 216 U. S., 400, 417.....	52
Southern Ry. Co. v. McNeill, 155 Fed., 756.....	101
Spencer v. Lowe, 198 Fed., 961 (C. C. A.).....	26, 86
Stanton v. Baltic Mining Co., 240 U. S., 103.....	82, 85
Stockdale v. Insurance Cos., 20 Wall., 323.....	68
Stokes, <i>In re</i> , 240 Pa. St., 277 (1913).....	40
Strasser v. Staats, 59 Hun, 143.....	87, 90, 93, 95
Stratton's Independence v. Howbert, 231 U. S., 399.....	105
Tebrau (Johore) Rubber Syndicate v. Farmer, 5 Tax Cas., 658.....	68, 104
Thayer v. Burr, 201 N. Y., 155.....	33
Thorn v. de Breteuil, 86 App. Div., 405, 415.....	7, 51
Towne v. Eisner, 242 Fed., 702; U. S. Sup. Ct., Jany. 7, 1918.....	82
Tyee Realty Co. v. Anderson, 240 U. S., 115, 117.....	51
Union Pacific Coal Co. v. Skinner, U. S. Dis. Court, District of Colo., March 2, 1917 (unreported).....	38, 80
U. S. v. American Sugar Refining Co., 202 U. S., 563.....	38, 80
U. S. v. Burr, 159 U. S., 78.....	52
U. S. v. Collier, 3 Blatchf., 325; Fed. Cas. No. 14,833.....	78
U. S. v. Delaware & Hudson Co., 213 U. S., 366, 408.....	78
U. S. v. Jin Fuey Moy, 241 U. S., 394, 401.....	101
U. S. v. Milwaukee, etc., Co., 142 Fed., 247.....	52
U. S. v. Smith, 1 Sawy., 277; Fed. Cas., No. 16,341.....	99
U. S. v. Southern Pacific Co., 239 Fed., 998 (C. C. A.).....	24
U. S. v. Venable Co., 124 Fed., 267.....	88
Van Doren v. Olden, 19 N. J. Eq., 176.....	

	PAGE
Vinton's Appeal, 99 Pa. St., 434.....	104
Von Baumbach v. Land Co., 242 U. S., 503, 519.....	88
Wheeler v. Perry, 18 N. H., 307.....	44
Wilberding v. Miller (Ohio), 106 N. E., 665.....	44
Wisconsin Steel Co. v. Maryland Steel Co., 203 Fed., 403, 406 (C. C. A.).....	24

OTHER AUTHORITIES.

26 Am. Law Review, 18.....	72
Black on Income Taxes (2nd Ed.), Secs. 212, 218, 219, 377, 380, 381.....	33, 52, 82, 90, 113, 114
Bouvier's Law Dictionary, Rawles Rev.....	40
Commissioner of Internal Revenue's letters of Feb. 5, 1915, to Corporation Trust Co. and of March 8, 1915, to Matz, Fisher & Boyden.....	42
Concise Oxford Dictionary.....	40
Con. Rec., Aug. 26, 1913, Vol. 50, No. 97, pp. 4192, 4193.....	32
Cook on Corporations, Vol. II, 7th Ed., Secs. 544, 552, 554, 555, 663, 664.....	66, 71, 101, 107
Cooley on Taxation, 3rd Ed., Vol. I, p. 4.....	96
Cyc., Vol. 8, 731, 745.....	80
Foster on Income Tax, Sec. 46.....	32, 102
Gray on Limitations on Taxing Power, 353.....	96
Morawetz on Corporations, 2nd Ed., Secs. 227, 467.....	67, 101
Perry on Trusts, Vol. II (6th Ed.), 556.....	41
Senate Report No. 80, 63rd Cong., 1st Sess.....	83
Thompson on Corporations, Vol. V (2nd Ed.), Secs. 5410, 5414.....	68, 72
Treasury Decision 2135.....	93
Wigmore on Evidence (Sec. 1530).....	19, 23

STATUTES CITED.

Constitution, Art. I, Secs. 2, 8, 9.....	78
Constitution, Fifth Amendment.....	97
Constitution, Fourteenth Amendment.....	78
Constitution, Sixteenth Amendment.....	78
13 Stat. 1, 281, 284, Secs. 117, 122.....	45, 55
14 Stat. L., 478.....	59, 63
16 Stat. L., 257, Sec. 7.....	45
30 Stat. L., 448.....	95
38 Stat. L., 114.....	1, 29
39 Stat. L., 757, Sec. 2 (a); 766, Sec. 10.....	27, 53
Federal Judicial Code, Sec. 238.....	26
Interstate Commerce Act, Sec. 20.....	7
War Revenue Law, 1917, Sec. 1211.....	27, 54
New York Code of Civil Procedure, Sec. 939.....	18
Utah, Compiled Laws, Sec. 4411.....	106
British Income Tax Act (16 and 17 Vict., c. 34).....	104

Supreme Court of the United States.

OCTOBER TERM, 1917.

SOUTHERN PACIFIC COMPANY,
Plaintiff in Error,

v.

JOHN Z. LOWE, JR., United States
Collector of Internal Revenue
for the Second District of New
York.

No. 452.

BRIEF FOR PLAINTIFF IN ERROR.

STATEMENT OF FACTS.

This is a writ of error to the District Court of the United States for the Southern District of New York, to review a judgment entered upon a verdict directed by the court in favor of the defendant.

The Southern Pacific Company, the plaintiff in error and plaintiff below (hereinafter referred to as the "plaintiff"), brought this action to recover taxes paid by it, under protest, which the defendant claimed the right to collect under the terms of the Federal Income Tax Act of 1913 (38 Stat. L., 114), hereinafter referred to as the "Act." The complaint contains two causes of action, both involving substantially the same questions of law. As the proof of the facts involved in the second cause of action was simpler, it was

stipulated that the trial of the first cause of action might be postponed until the determination of the second cause of action, in order to test the correctness of the Treasury Department's construction of the Act with as little expense as possible (R., a17), so that we are here concerned only with the latter cause of action.

The tax sought to be recovered was imposed on five dividends, aggregating \$21,512,296.64, received by the plaintiff from other corporations in the first half of the year 1914. These dividends had been paid out of surpluses accumulated by the latter corporations, not only prior to the adoption of the Sixteenth Amendment to the Constitution of the United States, but several years prior to that time.

Four of the dividends in question were paid to the plaintiff by the Central Pacific Railway Company (hereinafter called the "Railway Company"). Three of these dividends and at least a portion of the fourth were paid out of a surplus which had accrued to the latter company prior to July 1, 1909; and constituted a distribution of practically the entire surplus of that company. The payment of the dividends was constructive merely, as the plaintiff had had possession of the funds from which the dividends were paid long prior to their declaration. There was no actual cash settlement between the two companies (R., 74, 125). The payment was effected by book entries by means of which the indebtedness due from the

plaintiff to the Railway Company was liquidated to the extent of these dividends (R., 35-37).

At least \$3,401,448.48 of the surplus from which these four dividends had been paid had arisen from the sale of capital assets, such assets consisting of lands granted to the Railway Company by the United States to aid it in the construction of its line of road (R., 56).

The fifth dividend, amounting to \$26,666.64, was paid by the Reward Oil Company; but as the cost of proving the facts connected with this dividend would necessitate the taking of voluminous depositions, the expense of the proof would be greater than the amount of the tax, namely, \$266.67. This item has, therefore, been abandoned.

The plaintiff and its subsidiary corporations, including the Railway Company, form a unified transportation system. The earnings of all the companies are kept together, the plaintiff acting as the banker of the system (R., 97-98). The Railway Company has no bank account, but its earnings are deposited in the plaintiff's bank accounts (R., 37, 73). If the Railway Company needs moneys for additions and betterments or other purposes, the necessary expenditures are made by the plaintiff (R., 73-74, 97, 102). Proper entries are made on the books of the two corporations (R., 35, 100-101); but, as a practical matter, no distinction is made as to the ownership of the funds (R., 97-98). The plaintiff is and has been the lessee of the railroads and appurtenant

properties of the Railway Company at all times since the incorporation of the latter in the year 1899 (R., 5; Exhibit "E", 152, 36, 197). In other words, the former company was not only in possession of the moneys of the latter company, but of nearly all of its other assets long prior to the declaration of the four dividends in question.

The plaintiff has owned the entire capital stock of the Railway Company ever since the latter's incorporation (R., 5). As the stock thus owned represented all of the Railway Company's assets, including the surplus distributed by these dividends, the plaintiff was made neither richer nor poorer by their declaration and payment.

PROOF OF FACTS.

During the first six months of the calendar year 1914, the plaintiff received the following dividends from the Railway Company, viz. (Exhibit "2-H," R., 148):

Extraordinary dividend of 20% on preferred stock	\$3,480,000
Extraordinary dividend of 20% on common stock	13,455,100
Extraordinary dividend paid from sale of Rockaway Beach property (on preferred stock \$105,627, on common stock \$408,373)	514,000
Annual dividend on common stock	4,036,530
Semi-annual dividend on preferred stock	522,000

No other dividend was paid by the Railway Company during the entire fiscal year ending June 30, 1914, except a second semi-annual dividend of \$522,000 on the preferred stock (R., 171).

The dividends in controversy in this action include all those above mentioned, except the two dividends of \$522,000 each on the preferred stock. The amended complaint, however, demands the refund of the tax, not on the whole, but on only \$912,497.48 of the dividend of \$4,036,530 on the common stock (R., a10).

The two extraordinary dividends of twenty per cent. (aggregating \$16,935,100) paid in January, 1914, on the preferred and common stock of the Railway Company were, by the terms of the resolutions declaring them, payable out of surplus accruing prior to January 1, 1913 (Exhibits "A" and "B," R., 150), while the Sixteenth Amendment to the Constitution was not adopted until the end of February, 1913. All four of the dividends in controversy were charged on the Railway Company's books as paid from surplus (Exhibit "G," sheet 3, items 4 and 5, for year ending June 30, 1914, R., 166). Had these dividends been paid from earnings instead of surplus they would appear in Exhibit "G," Sheet 1, as a deduction from gross income, instead of a debit to profit and loss. The entries on the corporate books showing these dividends to have been paid from surplus, and the testimony of the Railway Company's officers, would seem to be sufficient proof of the

source from which they were paid; but, in order to "make assurance double sure," evidence has been introduced of the net credit or debit to surplus for each of the five fiscal years from July 1, 1909, to and including June 30, 1914. This evidence shows that for the five years in question no net surplus resulted from the operations of the Railway Company sufficient for the payment of the four dividends, and that therefore they must have been paid from surplus accruing prior to July 1, 1909. It was, however, necessary to show only that the dividends were paid from a surplus accruing prior to February 28, 1913 (the date of the adoption of the Sixteenth Amendment). The details of this proof will now be considered.

Exhibit "G" was prepared from the corporate books under the instructions of the Auditor (R., 23). This exhibit, sheet 1, gave an itemized statement of the gross income of the Railway Company, and also of the deductions from gross income, showing on the bottom line the net income for each of the five fiscal years from July 1, 1909, to and including June 30, 1914. Sheet 2 gave an itemized statement of the credits, and sheet 3 an itemized statement of the debits, to profit and loss for the same five years. The exhibit was prepared from the Railway Company's Ledger and Journal (R., 23) by a bookkeeper named Lincoln, and is a correct copy of the entries as they appear in the Journal (R., 52, 47-48), "an exact copy of the

debits and credits to income and profit and loss" (R., 73). The Ledger and Journal are the original books of the Railway Company (R., 52). The accounts of the Railway Company are all kept in accordance with the rules and regulations of the Interstate Commerce Commission (R., 57, 101). The Interstate Commerce Act requires railway accounts to be so kept (Sec. 20). The Railway Company's earnings "are accounted for with great care" (R., 100). Lincoln prepared Exhibit "G" by first referring to the Income and Profit and Loss Accounts in the Ledger and then to the Journal for the Journal entries posted therein; and made up the statement by copying the Journal entries exactly (R., 52, 73). The statement contains no accounts that are not to be found in the Journal and Ledger (R., 73), but does not contain all of the accounts to be found there. All asset and liability accounts were omitted (R., 112), as the object of the statement was to show, not capital accounts, but the net deficit or surplus resulting each year from operations.

Exhibit "H" (R., 167) is a correct summary of Exhibit "G," and was also prepared by Lincoln under the direction of the Railway Company's Auditor (R., 34-35, 52-53). It shows the surplus on June 30, 1909, and the surplus at the close of each fiscal year thereafter up to and including June 30, 1914 (R., 53). Referring to this exhibit, we find that on June 30, 1909, the Railway Company had a surplus of \$25,250,361.91; that

after the payment of dividends the Railway Company ended the next succeeding fiscal year with a net credit to surplus of \$2,747,244.29, having on June 30, 1910, therefore, a surplus of \$27,997,606.20; and that after the payment of dividends the Railway Company ended the next succeeding fiscal year (1910-1911) with a net debit to surplus of \$5,047,155.82. In other words, the dividends paid in the fiscal year ending June 30, 1911, exceeded the net earnings for the year by the sum last mentioned. The result of the operations for the two years, after the payment of dividends, was therefore a deficit. The next succeeding fiscal year (1911-1912), after payment of dividends, showed a net credit to surplus of \$1,092,301.12, but the next succeeding fiscal year (1912-1913), after the payment of dividends, showed a deficit of \$1,960,288.14. This deficit was larger than the net credit to surplus for the year preceding, so that the result of the operations for the two years ending June 30, 1913, was a deficit. Therefore a deficit from operations for the four years after the payment of dividends, resulted. This can readily be proved by noting that the total surplus was less on June 30, 1913, than on June 30, 1909. Moreover, as there was on June 30, 1913, after the payment of dividends, a deficit for the year, it follows that any dividends paid in the next succeeding fiscal year ending June 30, 1914, insofar as they exceeded the earnings and profits of that year, must have been paid out

of a surplus accruing prior to July 1, 1912; and as the result of the four prior years had also been a deficit, it further follows that such dividends must have been paid from a surplus accruing prior to July 1, 1909. Now, Exhibit "H" shows that the earnings and profits of the year ending June 30, 1914, that is, the net credit to surplus, were \$2,767,295.80, and that the total dividends paid during this year were \$22,529,630 (R., 30). Therefore, it follows that the two extraordinary dividends of twenty per cent. each on the preferred and common stock of the Railway Company paid in January, 1914, and the third dividend (an extraordinary dividend of \$514,000 likewise paid on the preferred and common stock in January, 1914) must have been paid wholly out of surplus accruing prior to July 1, 1909; also that at least \$2,313,234.20 of the fourth dividend (a six per cent. dividend paid on the common stock in June, 1914) must also have been paid out of surplus accruing prior to July 1, 1909. The conclusion above stated follows because it is conceded that the two regular dividends of \$522,000 each on the preferred stock were paid from current earnings, so that of the net surplus of \$2,767,295.80 for the year but \$1,723,295.80 is left for the payment of the four dividends in controversy. It follows, therefore, that all three of the extraordinary dividends must have been paid from surplus, and that all of the fourth dividend must have been paid from surplus except \$1,723,295.80. Subtract the sum last

mentioned from the fourth dividend of \$4,036,530 and the remainder, viz: \$2,313,234.20, is the amount which must have been paid from surplus.

The dividends paid in the fiscal year ending June 30, 1914, exceeded the surplus for that year by \$19,762,334.20 (R., 30-31).

During the trial in the lower court, the defendant questioned some of the debits on sheet 3 of Exhibit "G," on the ground that a portion of the debits there shown as entered in the five years 1910 to 1914 inclusive related to transactions prior to July 1, 1909; but Exhibit "J" shows that the credits relating to transactions prior to July 1, 1909, exceed the debits relating to similar transactions by \$3,011,811.37 (R., 174). In other words, if the entries had in each case been made when the transaction occurred, instead of subsequently, the surplus shown by Exhibit "G" for July 1, 1909, would have been increased by, \$3,011,811.37, and the net surplus accruing during the succeeding five years would have been correspondingly diminished (R., 54-55). Moreover, while at least \$2,313,234.20 of the dividend paid in June, 1914, was paid out of surplus accruing prior to July 1, 1909, the recovery of the tax on only \$912,497.48 of this dividend is here sought (R., a10). As it is believed that the defendant will concede that a substantial portion, if not all, of the four dividends in controversy were paid from a surplus accruing prior to July 1, 1909, the subject will not be discussed further, except to say that in order to require a reversal of the judgment of the

lower court it is necessary only to show that the plaintiff is entitled to recover a portion of the tax in question; and if any portion of these dividends was paid from a surplus accumulated prior, not to July 1, 1909, but to the adoption of the Sixteenth Amendment to the Constitution, then the direction of a judgment for the defendant was reversible error.

If we confine our consideration of the proof of net surplus to the period elapsing between the date of the adoption of the Sixteenth Amendment and June 30, 1914, it is more than ever manifest that no such net surplus was earned in this period as permitted the payment of these large dividends.

The figures which we have heretofore discussed are the result of the operations of the Railway Company as shown by the accounting rules and regulations of the Interstate Commerce Commission. The regulations of the Treasury Department under the terms of the Act and of the Federal Corporation Tax Act of 1909 prescribe somewhat different methods of accounting in order to ascertain a corporation's net income. In view of the defendant's objection to the figures offered by the plaintiff that "the items going to make up the amount named are not shown to be proper deductions from gross income, or deductions which should be allowed *either under the corporation tax act or the income tax law*" (R., 29), the plaintiff supplemented the foregoing evidence by further proof designed to meet this objection. Exhibits "K" and "L," each composed of two

sheets, known as C. T. 1 and C. T. 2 respectively (that is, Corporation Tax, sheet 1, and Corporation Tax, sheet 2), are forms prepared from the Journal and Ledger for use in the preparation of the income tax returns for 1913 and 1914 (R., 61-64).

Exhibit "N" is substantially the same as Exhibit "G," except that Exhibit "N" is prepared on the basis of the Treasury Department's corporation tax and income tax regulations, instead of the Interstate Commerce Commission's regulations (R., 65-66).

Exhibit "O" is a letter from the Commissioner of Internal Revenue to the Railway Company, suggesting certain corrections in its corporation tax returns, the principal correction being the exclusion as a deduction from gross income of interest insofar as such interest was paid on funded debt in excess of the sum of the capital stock and one-half of the company's indebtedness (R., 183).

Exhibit "P" is a copy of the Railway Company's income tax returns for the calendar year 1913 and the six months' period ending June 30, 1914, showing (of course, in each case prior to the payment of dividends) a net income of \$4,000,-615.42 for the former and a deficit for the latter period (R., 186-189). The Commissioner of Internal Revenue accepted these returns as correct after they had been amended in accordance with Exhibit "O" (R., 67, 91).

Exhibit "Q" is substantially similar to Exhibit "N," except that it is prepared in accordance with

the corrections suggested in Exhibit "O," the letter of the Commissioner of Internal Revenue (R., 85-86). The last two lines of the second sheet of Exhibit "Q" show the net surplus or deficit for each of the five years (R., 191).

Exhibit "S" is a summary of Exhibit "Q," and shows that the dividends paid in the fiscal year ending June 30, 1913, exceeded the net surplus of that year by \$1,666,595.52. Hence, the four dividends in question, insofar as they exceeded the net surplus for the fiscal year ending June 30, 1914, must have been paid from a surplus accrued prior to July 1, 1912. The net credit to surplus for the fiscal year ending June 30, 1914, was \$339,849.32, while the dividends paid in that year amounted to more than \$22,500,000. Consequently all four of the dividends (aggregating \$21,485,630) received by the Plaintiff from the Railway Company and in controversy in this action must have been paid from a surplus accrued prior to July 1, 1912, and (though it is not material to go back further) an examination of the figures contained in Exhibit "S" will show that substantially all of these four dividends must have been paid from a surplus that arose prior to July 1, 1909 (R., 193-195).

SUFFICIENCY OF PROOF.

The position of a taxpayer in controversies with the Government is an unequal one. The Internal Revenue officers have power arbitrarily to collect any taxes which they claim to be due. By

reason of this arbitrary power, the plaintiff was compelled to pay disputed taxes on the dividends in question. Hence, it is surprising that these officials should have sought to prevent the plaintiff from testing the correctness of their contention. Although accorded free access to the books and records of the Railway Company (R., 59, 66, 130-131)—the criterion accepted for the determination of the tax in all other cases—the defendant objected to proof of income by the corporate books, verified by the testimony of the employees making the entries therein and of the officers in charge thereof. The expense and difficulty of any other method of proof were prohibitive, so that the objection, if sustained, would have prevented the question of the propriety of the Treasury Department's contention from being adjudicated, and would have resulted in the Government's retaining possession of several hundred thousand dollars of taxes to which its right was at best doubtful. Even technical objections to papers being copies, and not originals, were made. These objections were not withdrawn until the plaintiff stated it would produce the originals (R., 12, 13), and it therefore appeared that no advantage would accrue to the defendant from standing upon a technicality. It is because of this attitude on the part of the Government that it becomes necessary to discuss the sufficiency of the proof.

The Railway Company owns 2,300 miles of road (R., 104). The number of employees con-

cerned in its affairs is larger than would usually be the case, even with a railroad company of its size, owing to the fact that its railroads are leased to the plaintiff and most of the latter's employees are concerned with the affairs not only of the Railway Company but concurrently with the affairs of the other companies from which the plaintiff holds leases (R., 99, 104). The plaintiff's Pacific System alone comprises 7,000 miles (R., 104). It would manifestly be impossible to prove the net corporate surplus of a company of the size of the Railway Company by the testimony of each employee making a collection or expenditure on its behalf. This would involve summoning every train conductor, every freight or passenger clerk, every attorney who collected a judgment in its favor, every cashier, &c. Then, in turn, the persons to whom these employees reported must be called to prove that they had entered the reports correctly, and so on through the chain of employees, until finally we reached the accounting officer in charge of the principal books of the Railway Company. While such strict proof would work no hardship in the case of a small concern employing two or three clerks, to demand evidence of this character in the case of a great corporation would be to deny it judicial redress wherever its accounts were concerned.

Therefore, in order to prove the net credits or debits to surplus, statements composed of copies

of all entries from the Railway Company's Income and Profit and Loss Accounts were offered in evidence. These statements contained copies of all entries in the Journal and Ledger, except asset and liability entries. The books were testified to have been kept correctly in accordance with the accounting regulations of the Interstate Commerce Commission (R., 57, 101). The figures contained in the books were verified by the Auditor (Edwards), by the Assistant Auditor (Adams), and by Lincoln, Duffy and Johnson (bookkeepers). The three last mentioned made all the entries in the Journal and Ledger during the five fiscal years in question, except those made by a man named Folsom, who was dead (R., 37-39).

Reports were entered in the Cash Book, Journal and Ledger currently as received (R., 38, 43). From 80 to 100 such reports were received each month from the Treasurer's office, the Assistant Auditor's office, the Land Department, the Auditor's office, and the New York office (R., 39, 46, 51). Duffy and Lincoln, as far as possible, verified the accuracy of all reports before entering them in the books (R., 41, 46). Reports also came from Miscellaneous Accounts Bureau (R., 44). The reports so received were made up by the following number of employees: 12 in the Assistant Treasurer's office, 30 in the Miscellaneous Accounts Bureau, 25 in the Land Department, and indirectly by about 700 in the disbursements, freight, passenger and equipment service offices,

who made reports and passed them to the Miscellaneous Accounts Bureau. The employees named are in addition to those in the New York office (R., 43-44). The Auditor of Disbursements has about 100 employees in his office; Miscellaneous Accounts about 90; and the Assistant Treasurer about 15 at San Francisco (R., 98-99).

The Auditor of Disbursements gets his figures from labor and material distribution which he receives from various sources and particularly from the Division Superintendents' offices, of which there are 10 in the Pacific System. The Miscellaneous Accounts Bureau receives its data from other accounting offices: the Auditor of Freight Accounts, Auditor of Passenger Accounts, and Auditor of Disbursements, also from the Assistant Treasurer's office, and from station agents, conductors, &c. The reports of the Assistant Treasurer's office are based upon the receipts and disbursements of the Company, the receipts coming very largely from station agents and conductors, from other railroad companies and from the public for bills rendered, and the disbursements consisting chiefly of the Company's payrolls, and vouchers and drafts drawn in settlement of traffic balances. The receipts and disbursements are entered on abstracts and reported to the Miscellaneous Accounts Bureau daily. These reports include the operations, not only of the Railway Company, but also of the other roads leased by the plaintiff (R., 99). Great care is used in the

apportionment of expenses and revenue between the various lessor companies (R., 100). The Journal and Ledger contain all the corporate accounts of the Railway Company (R., 51-52). They are the original books of the Company (R., 52).

Lincoln, with the assistance of Holbrook, prepared the income tax returns of the Railway Company (R., 57), and these returns were offered in evidence and verified by the testimony of these two witnesses (Exhibit "P," R., 186). The Commissioner of Internal Revenue had accepted the returns and assessed a tax against the Railway Company thereon, except on the return for the period ended June 30, 1914, which showed a deficit (R., 67, 91).

The defendant's counsel was accorded free access to the books and records of the Railway Company (R., 59), and had an examination of the accounts of both companies made by United States Internal Revenue examiners (R., 130-131).

Objections to the exhibits above mentioned on the ground that they were copies, and that the original books were not introduced in evidence, were waived by stipulation (R., 149):

It is expressly provided by the New York Code of Civil Procedure that (Sec. 929):

"Where a party wishes to prove an act or transaction of a foreign corporation, the book or books of the corporation may be used for that purpose, as presumptive evidence, whether any or all of the parties are or are not members of the corporation."

The Railway Company within the meaning of the foregoing statutory provision is a foreign corporation, having been incorporated under the laws of Utah (R., 197).

Prof. Wigmore, in his work on Evidence, elaborately discusses the competency, as proof, of entries made by bookkeepers in the ordinary course of business on the reports of others, and reaches this conclusion (Sec. 1530) :

“Suppose an offer of books representing transactions during several months in a large establishment. In the first place, the employees have in many cases changed and the former ones cannot be found; in the next place, it cannot always be ascertained accurately which employee was concerned in each one of the transactions represented by the hundreds of entries; in the third place, even if they could be ascertained, the production of the scores of employees, to attend court and identify in tedious succession the detailed items of transactions would interrupt and disarrange the work of the establishment, and the evidence would be obtained at a cost practically prohibitory; and finally, the memory of such persons, when summoned, would usually afford little real aid. If unavailability or impossibility is the general principle that controls (*ante*, § 1521), is not this a real case of unavailability? Having regard to the facts of mercantile and industrial life, it cannot be doubted that it is. In such a case, it should be sufficient if the books were verified on the stand by a supervising officer who knew them to be the books of regular entries kept in that

establishment, and the production on the stand of a regiment of bookkeepers, salesmen, shipping clerks, teamsters, foremen, or other subordinate employees, should be dispensed with. . . .

"Such entries are dealt with in that way in the most important undertakings of mercantile and industrial life. They are the ultimate basis of calculation, investment, and general confidence in every business enterprise; nor does the practical impossibility of obtaining constantly and permanently the verification of every employee affect the trust that is given to such books. It would seem that expedients which the entire commercial world recognizes as safe could be sanctioned, and not discredited, by courts of justice. When it is a mere question of whether provisional confidence can be placed in a certain class of statements, there cannot profitably and sensibly be one rule for the business world and another for the court-room. The merchant and the manufacturer must not be turned away remediless because methods in which the entire community places a just confidence are a little difficult to reconcile with technical judicial scruples on the part of the same persons who as attorneys have already employed and relied upon the same methods."

Rowland v. R. Co., 244 U. S., 106, 108.

In *Northern Pacific Railway Company v. Keyes*, 91 Fed., 47, 58, a case involving the reasonableness of rates prescribed by the defendants, who composed the Board of Railroad Commissioners

of the State of North Dakota, the court said (Thayer and Amidon, *JJ.*):

“A large number of tables were prepared in the accounting departments of the several roads bearing upon different features of the business of the companies for the years 1894, 1895, 1896, and 1897. These tables were compiled pursuant to the directions of general officers, who testified that they were correct, according to their best judgment and belief. The record shows that from 40 to 50 clerks were employed by each of the companies in the preparation of the different tables. These clerks were not called to testify that the several computations made by them were correct, but the heads of departments under whose immediate supervision the work was done were called as witnesses, and the method of preparing the figures from which the tables were compiled was fully explained and their trustworthiness shown. The clerks were also present in the building where the testimony was taken, as were likewise the way bills and other records from which they made their computations. Counsel for defendants was invited to call any of the clerks for the purpose of cross-examination, and was given the freest access to all the papers and records from which the computations were made. He objected to the evidence upon the ground that it was incompetent. The objection cannot be sustained. To have called each of the clerks would have added very little to the trustworthiness of the evidence. No clerk conducted any entire investigation, but various details were placed in the hands of 40 or 50

different employees, and each contributed his computation to the general result. No clerk could have testified that the tables were correct, for the reason that they were not made by him; neither could any single clerk testify that the figures from which the tables were compiled were correct, for he only contributed a small fragment to the general result. The method adopted was the only practicable one for conducting the investigation. It would have been absolutely impossible for any one man to have compiled the general result without delaying the case for years. A reasonable safeguard against falsification in the preparation of such statements is furnished by placing the records from which they are compiled freely at the disposal of the adverse party. It was the duty of the companies to do this, and to give the attorney general the fullest assistance in explaining such records, and to allow him to place the same in the hands of expert accountants, if he so desired, for the purpose of detecting error or falsification in the testimony as prepared by the companies. The record shows that this was done throughout the taking of the testimony in these cases. We must assume that the attorney general was satisfied of the correctness of the testimony from the fact that he declined to investigate its truthworthiness" (pp. 58, 59).

In *Hitchner Wall Paper Company v. R. Co.*, 158 Fed., 1011, 1014, a suit to recover damages for the burning of a paper mill by sparks emitted from the railroad company's engines, the railroad company sought to identify the locomotives pass-

ing the mill just prior to the time of the fire and to show that each was equipped with a spark arrester. The positions of the various locomotives at and just prior to the fire was proved by the testimony of the train dispatcher of the division in which the mill was situated. The dispatcher had no personal knowledge as to the whereabouts of the locomotives; but testified from his train sheets, which were made up from information received by him by telegram from the various points and recorded by him at the time received. This evidence was held proper.

A similar ruling was made in *Chesapeake & Ohio R. Co. v. Stojanowski*, 191 Fed., 720, where the foregoing case is quoted with approval.

In *Louisville & Nashville R. Co. v. Daniel*, 122 Ky., 256, 265, a case highly commended by Mr. Wigmore in his work on Evidence, Sec. 1530, the court held that train sheets offered in evidence to prove the position of the Railroad Company's trains had been improperly excluded, and said:

“What was possible, and not unreasonably practicable, a century ago, would be intolerable in the conducting of business in this age. But the necessity of rules of evidence are the same, and the reasons for them, in the main, are not different. If a fact is in dispute, to be determined in or out of court, the safe course is a resort to the best evidence of which the nature of the case will admit, and such as has been found most reliable in the practical adjustment of such matters among those whose constant business it is to adjust them.

Mercantile and industrial life, producing, as they do, nearly all the transactions of men that come before the courts of law and equity, are essentially practical. That which is the final basis of action, of calculation, reliance, investment, and general confidence in every business enterprise, may safely, in general, be resorted to to prove the main fact. The courts need not discredit what the common experience of mankind relies upon. Such is the use of books or records of original entries made under circumstances that are a guaranty of their trustworthiness."

See also:

- Wisconsin Steel Co. v. Maryland Steel Co.*, 203 Fed., 403, 406 (C. C. A.);
Reyburn v. Savings Bank, 171 Fed., 609 (C. C. A.);
Heike v. U. S., 192 Fed., 83, 95 (C. C. A.);
American Surety Company v. Pauly, 72 Fed., 470, 478 (C. C. A.), affirmed 170 U. S., 133, 159;
Grunberg v. U. S., 145 Fed., 81, 95 (C. C. A.);
Feuchtwanger v. Malting Co., 187 Fed., 713, 717 (C. C. A.);
Mississippi River Logging Co. v. Robson, 69 Fed., 773, 781 (C. C. A.);
Ins. Co. v. Weide, 9 Wall., 677, 680;
Bates v. Preble, 151 U. S., 149, 155;
U. S. v. Venable Co., 124 Fed., 267;
City of St. Joseph, 205 Fed., 284 (C. C. A.);
Continental Bank v. First National Bank, 108 Tenn., 374, 380.

SPECIFICATION OF ERRORS.

A detailed assignment of errors will be found in the Record (R., 199-203). The principal propositions that will be argued are as follows:

The District Court erred in directing a verdict for the defendant and in denying the plaintiff's motion for the direction of a verdict in its behalf (R., 133-138), because—

First, the Act should not be construed as taxing, as a part of the plaintiff's net income, dividends from a surplus accumulated long prior to the adoption of the Sixteenth Amendment to the Constitution of the United States, even though such dividends were declared and paid to the plaintiff after such amendment;

Second, to construe the Act as imposing a tax on such dividends would render it unconstitutional, (a) as imposing a direct tax on capital without apportionment, and (b) as so arbitrary and unequal as to contravene the Fifth Amendment; and

Third, dividends paid to the plaintiff by another company out of the proceeds of the sale of capital assets are not taxable as a part of the plaintiff's net income.

ARGUMENT.**I.****Jurisdiction.**

As the constitutionality of a law of the United States is drawn in question, and the construction or application of the Constitution of the United States is involved (*post*, pp. 78, 96), the writ of error properly ran from this court to the District Court direct.

Federal Judicial Code, Section 238;
Towne v. Eisner, U. S. Sup. Ct., Jany. 7, 1918;
Stanton v. Baltic Mining Company, 240 U. S., 103;
Brushaber v. Union Pacific Railroad Company, 240 U. S., 1.

This question is more fully discussed in the plaintiff's brief in opposition to the motion to dismiss for lack of jurisdiction; and is foreclosed by the *Towne* case, *supra*.

Not merely the constitutional question, but all the questions in the case are reviewable.

Towne v. Eisner, *supra*;
Horner v. U. S., No. 2, 143 U. S., 570;
Carey v. R. Co., 150 U. S., 170;
Penn Mutual Life Ins. Co. v. Austin, 168 U. S., 685;
B. Altman & Co. v. U. S., 224 U. S., 583.

The request by both parties for a directed verdict was not equivalent to a submission of the case

to the court without the intervention of a jury, and the judgment below must be reversed, since there was no evidence to support it.

Beuttell v. Magone, 157 U. S., 154, 157;
Sena v. American Turquoise Company,
 220 U. S., 497, 501;
Empire State Cattle Company v. R. Co.,
 210 U. S., 1, 8.

II.

The Act should not be construed as imposing a tax on dividends paid from a surplus accumulated prior to the Sixteenth Amendment.

The importance of the precedent to be established by the decision of the case at bar is destroyed, so far as its effect upon the Government's revenue is concerned, by the amendments to the Act made by Congress in the years 1916 and 1917. In view of the adverse ruling of the Treasury Department, Congress inserted in the Income Tax Act of 1916 a provision explicitly defining taxable dividends to mean any distribution made by a company "out of its earnings or profits accrued since March 1, 1913" (39 Stat. L., 757, Sec. 2 (a), and 766, Sec. 10). A similar, but more elaborate, provision is contained in the War Revenue Law of 1917. The new law, after the phrase above quoted, added the following:

"But nothing herein shall be construed as taxing any earnings or profits accrued prior

to March 1, 1913, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March 1, 1913, has been made" (Sec. 1211, adding Sec. 31 to Income Tax Act of 1916).

(1) STATUTES IMPOSING TAXES MUST BE STRICTLY CONSTRUED AGAINST THE GOVERNMENT AND IN FAVOR OF THE TAXPAYER.

In *Gould v. Gould*, decided November 19, 1917, this court said, with regard to the Act (McREYNOLDS, J.):

"In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government and in favor of the citizen."

In *Eidman v. Martinez*, 184 U. S., 578, 583, the court said:

"It is an old and familiar rule of the English courts, applicable to all forms of taxation, and particularly special taxes, that the sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of *exception* confining the operation of duty. * * *

"We have ourselves had repeated occasion to hold that the customs revenue laws should be liberally interpreted in favor of the importer and that the intent of Congress to impose or increase a tax upon imports should be expressed in clear and unambiguous language."

(2) ANALYSIS OF THE ACT.

The statute subjects individuals to a tax of one per cent. "upon the entire net income arising or accruing from all sources in the preceding calendar year" (Clause A, subd. 1). Such net income is defined as including "gains, profits and income" less deductions and exemptions (Clause B). A similar tax is imposed upon corporations in almost identical language (Clause G, subd. a). It should be noted at the outset that the tax is laid not upon all receipts, but upon "*net income*"; also that the tax on corporations is imposed by reference to the provisions of the Act affecting individuals. The exact wording of the Act is:

"That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation * * *." [Clause G, subdivision (a).]

In the case of individuals, the gross income is elaborately defined and then certain deductions are provided for (subdivision B),

while, in the case of corporations, it is briefly provided that "net income shall be ascertained by deducting from the gross amount of the *income* of" the corporation received within the year certain specified items. The fact that the tax on corporations is largely imposed by reference to the portion of the Act imposing a tax on individuals obviated the necessity of again defining in detail what should constitute gross income. Manifestly, gross "income" was not intended to be synonymous with gross "receipts." Dividends received by the plaintiff in 1914 from a surplus accumulated by the Railway Company prior to 1909 did not form a part of the gross "income" of the plaintiff for the year 1914. As the plaintiff owned the entire capital stock of the Railway Company, and as this stock represented all of the latter company's assets, a constructive distribution of a \$20,000,000 surplus in 1914 had no effect upon the plaintiff's "gains, profits and income" for that year. Upon the distribution of the surplus, the stock of the Railway Company depreciated in value to the extent of the dividends in question, so that in the aggregate the plaintiff's wealth was not affected.

In the court below the defendant's counsel complained that the "plaintiff consistently throughout its brief confuses the provisions of the Act taxing individuals with those taxing corporations," but the tax upon corporations cannot be discussed without considering the provisions of

the Act taxing individuals, since the latter are incorporated by reference into the former. As was said by the court in *Gulf Oil Company v. Lewellyn*, 242 Fed., 709, 716 (where the same question was involved as in the case at bar), with reference to the cases of *Lynch v. Turrish*, 236 Fed., 653 (C. C. A.) and *Lynch v. Hornby*, 236 Fed., 661 (C. C. A.):

“The difference between the plaintiffs in those cases and the plaintiff in the present case is that they are individuals, while the plaintiff in the case at bar is a corporation. Such difference, however, is not material, because, as has been seen, under the law the income to be taxed is the same in the case of corporations as in the case of individuals. Moreover, Section 2, par. G, subd. (b), provides for the ascertainment of the net income of a corporation by making deductions, not from its *gross receipts*, but from its ‘gross income.’ ”

(a) *Not all “income,” in the sense of everything that comes in, is taxed; but only income that consists of gains or profits.*

The proper definition of the word “income,” as it appears in the Act, was well stated by Senator John Sharp Williams, speaking in the Senate for the committee that had charge of the bill. He said:

“ ‘Income’ means the net gains or profits.
• • • A man’s taxable income means his gains

and profits during the year. Those gains and profits or income derived from any business of any description are taxed. If a man is engaged in dealing in horses, if he buys horses and sells horses and makes a profit or an income out of that dealing, he must pay a tax upon the income."

Cong. Rec., August 26, 1913, Vol. 50, No. 97, p. 4192.

He answered the suggestion that the word "income" might be held to mean receipts of every sort, as follows:

"The income within the contemplation of a tax law does not mean that. It means net income, and is so defined in the bill. That means profits or gains."

Id., p. 4192.

Senator Williams further stated that he saw no objection to striking out the word "income" altogether (*id.*, p. 4193).

The Act should not be construed to tax everything received by the person or corporation subject to tax; otherwise the words "gains" and "profits" are given no meaning. For, if "income" means everything that comes in, it is so comprehensive as necessarily to embrace all gains and profits. The true function of the words "gains" and "profits" is to limit the meaning of the word "income" and to show that the latter word was used only in the sense of receipts which constitute an accretion to capital.

Foster on Income Tax, Sec. 46.

Says Black on Income Taxes (2nd Edition),
Sec. 219:

"If it is doubtful whether or not a particular fund or acquisition is taxable as 'income,' under the statute, it is not taxable unless it is income in the nature of 'gain' or 'profit.' "

On the other hand, the function of the word "income" is to limit the meaning of the words "gains" and "profits." The increased value of capital assets constitutes in one sense a gain or profit, but not income. Hence, such gain or profit is not taxable, but only such gains and profits as constitute income.

Gray v. Darlington, 15 Wall., 63;
Gauley Mountain Coal Company v. Hays,
230 Fed., 110 (C. C. A.);
Doyle v. Mitchell, 235 Fed., 686 (C. C.
A.);
Baldwin Locomotive Works v. McCoach,
221 Fed., 59 (C. C. A.);
Industrial Trust Co. v. Walsh, 222 Fed.,
437.

Income from capital has been accurately defined in *People v. Davenport*, 30 Hun, 177, 186, as "that which it earns, remaining itself intact."

Thorn v. de Breteuil, 86 App. Div., 405,
415.

In *Lawless v. Sullivan*, L. R., 6 App. Cas., 373, 379, a case involving the construction of the

British income tax act, the Privy Council, speaking through Sir Montague E. Smith, said:

"It was not and could not be contended on behalf of the assessors that 'income' in the enactment meant all the takings or moneys received by a bank or in a trade from customers or otherwise; and it was not denied that it meant profits, in some sense of that word."

So the Act specifically provides that payments returned by insurance companies at the maturity of the policy or upon its surrender shall not be included as income (Clause B); for though they come in, they constitute neither gains nor profits.

Often receipts come in which are but a change of capital investment, or which represent a distribution of capital assets. In that case there is no gain or profit. If such receipts are regarded as income, the taxpayer's capital is depleted. Suppose on December 1, 1912, a resident of New York bought a hundred shares of bank stock and paid therefor \$410,000, the market value of these shares, viz., \$4,100 per share of \$100 par value. The next March the bank decides to distribute its entire surplus, all earned prior to the year 1913; and declares an extraordinary cash dividend of \$4,000 per share. The purchaser of the one hundred shares would receive \$400,000 in cash and would still retain his one hundred shares, which would be worth \$100 per share, instead of \$4,100. He immediately sells the one hun-

dred shares and receives therefor \$10,000. His total receipts from the dividend and sale of his shares are \$410,000, the amount with which he started a few months before. Yet, according to the Treasury Department's construction of the Act, he must treat \$400,000 as a profit and pay a large tax thereon. There has, however, been no gain or profit. Such a dividend would be analogous to a dissolution dividend and constitute a distribution of capital. Where the surplus distributed by the bank accrued in prior years, it has for the purposes of the Act become capital, and when declared as a dividend is a distribution of capital. It is not a distribution of gains, profits and income.

In the case at bar the plaintiff was made neither richer nor poorer by the payment of the dividends in controversy. It has owned the entire capital stock of the Railway Company ever since the latter's incorporation. Moreover, the former company has had actual possession of the assets of the latter during the Railway Company's entire existence; and therefore had possession of the assets out of which these dividends were paid long prior to their declaration. The defendant argues that a stockholder cannot compel the payment of a dividend. He can, however, obtain the benefit of an earned surplus by the sale of his stock; and in the present case the plaintiff absolutely controlled the situation. Not only did it have actual possession of all the Railway Com-

pany's assets; but as testified by the plaintiff's vice-president in answer to the defendant's suggestion that the plaintiff did not control the Railway Company's board of directors: If the board had not distributed the surplus as a dividend when asked to do so by the plaintiff, the latter would soon have supplanted them by a board that would (R., 126).

In *Collector v. Hubbard*, 12 Wall., 1, 17, a stockholder had paid under protest a tax on his undistributed share of his corporation's surplus. The tax was levied under the Federal income tax law of 1864. The court upheld the validity of the tax, and said that for income tax purposes stockholders were the owners of the undistributed profits of their corporation. From the premise that stockholders own the undistributed surplus of their corporation, the conclusion follows that the surplus must become their property when earned by the corporation, and not when declared or paid as a dividend. A portion of the opinion is as follows:

"Decided cases are referred to, in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being declared, and it cannot be doubted that those decisions are correct as applied to the respective subject-matters involved in the controversies. Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its inci-

dents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation, they serve to increase the market value of the shares, whether held by the original subscribers or by assignees. But the decisive answer to the proposition is that Congress possesses the power to lay and collect taxes, duties, imposts, and excises, and it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards, and it is clear that Congress did direct that all such gains and profits, whether *divided or otherwise*, should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act. Annual gains and profits, whether divided or not, are property, and, therefore, are taxable."

Bailey v. R. Co., 106 U. S., 109;

Lynch v. Turrish, 236 Fed., 653, 656 (C. A.);

Lynch v. Hornby, 236 Fed., 661 (C. C. A.);
Reynolds v. Williams, 4 Biss., 108; Fed. Cas., No. 11, 734;
Merchants Ins. Co. v. McCartney, 1 Lowell, 447; Fed. Cas., No. 9, 443.

The rulings of the Treasury Department itself recognize that all dividends do not constitute income by holding that a dissolution dividend of the entire capital and surplus of a corporation does not constitute taxable income. Yet what valid distinction can be made between a distribution of surplus by a going concern and a distribution of surplus on the dissolution of the corporation?

To construe the Act as imposing a tax on dividends from a surplus accruing prior to January, 1913, would result in giving the Act a retroactive effect and would violate a cardinal rule of statutory construction.

U. S. v. Burr, 159 U. S., 78;
U. S. v. American Sugar Refining Co., 202 U. S., 563;
Lynch v. Turrish, 236 Fed., 653 (C. C. A.).

What the Act means by the words "gains, profits and income," therefore, is not receipts derived from a conversion of capital, such as the distribution of a pre-existing surplus, but a net accretion to capital during the tax year, the capital itself remaining intact.

(b) *It is not enough that gains or profits were received within the year, but they must have been gains or profits "arising or accruing" during such year.*

The taxpayer's taxable receipts are his "entire net income arising or accruing" during the year [Clause G, subd. (a); see also Clause A, subd. 1].

This language is not indicative of an intention to tax receipts merely because received in a given year, but is strongly suggestive of an intention to look further and ascertain at what time the gain or profit became an accretion to capital. In the two most important clauses of the statute, the one imposing a tax on individuals and the other imposing a tax on corporations, the language is the same. It is not the net income *received within* the year, nor even the net income that *accrued or arose within* the year, but it is the net income *arising or accruing during or in* the year. The language is that of a continuing, not a completed, transaction. The statute looks to the period "during" which the accretion to capital is gradually taking place, not the moment at which it is actually reduced to possession.

It is true that in some portions of the Act different phraseology is used that might indicate an intention to tax receipts, but in the two important clauses imposing the tax, the language is chosen with nicety. These are the two paramount clauses and define the tax. Other clauses of the Act should be construed with reference to them.

The meaning of the word "accrue" was considered in *Anderson v. Richards' Executors*, 99 Ky., 661. It was there held that rent should be apportioned between the lessor's executors and the devisee of the land as of the date of the lessor's death, the Court saying:

"The contention of appellant [the devisee] seems to be that, inasmuch as the rent was not due or the term ended at the date of the death of the testator that the whole of such rent must be deemed to have accrued after the death of the testator. We find that Mr. Webster defines accrue: 'First, to increase; to augment. Secondly, to come to by way of increase; to arise or spring as a growth or result; to be added as increase, profit or damage, especially as the produce of money lent; interest accrued to principal.'"

Bouvier's Law Dictionary, Rawle's Rev., gives the following definition: "Accrue: To grow to; to be added to, as the interest accrues on the principal * * *."

The Concise Oxford Dictionary defines the word as to "Fall to one from a thing as a natural growth, advantage, result; especially of interest on invested money."

Strasser v. Staats, 59 Hun, 143, held that a by-law of a mutual benefit association, providing that the dues of members shall "accrue weekly" meant that the dues were to be established or measured weekly, and did not mean payable weekly.

Black defines the word "accruing" as meaning "inchoate; in process of maturing; that which may or will at a future time ripen into a vested right, an available demand, or an existing cause of action."

Ercanbrack v. Faris, 10 Idaho, 584;
Carley v Mfg. Co., 81 N. J. L., 502, 508;
Leman v. Chipman, 82 Nebr., 392, 396;
In re Mifflin's Estate, 232 Pa. St., 25.

All the authorities give "arise" as one of the synonyms of "accrue."

Although interest is not payable until a subsequent date, it is regarded as accruing from day to day. It is apportionable between life tenant and remainderman.

2 Perry on Trusts (6th Edition), 556, says:

"Interest-money upon notes, bonds, mortgages, and similar securities *accrues* from day to day, although it is not payable until a fixed day; it is therefore apportionable and trustees must pay the proportion accruing during the life of the tenant for life to his representative."

Bridgeport Trust Co. v. Marsh, 87 Conn., 384, 398, and cases cited.

The Treasury Department supports this construction by holding that one who purchases a bond between two interest dates is not liable for an income tax on so much of the interest as had accrued at the time of purchase, notwithstanding

the interest was not then payable, but became due later. (See Commissioner of Internal Revenue's letters of February 5, 1915, to Corporation Trust Company and of March 8, 1915, to Matz, Fisher & Boyden.)

So, also, the Treasury Department rules that an interest coupon which was payable prior to March 1, 1913, does not constitute taxable income, even though collected by the couponholder after that date. In such case the interest, though it comes in after March 1, 1913, is not a gain or profit "arising or accruing" during the tax period in which collected.

The use, in imposing the tax, of a phrase that is universally applied to the gradual accretion of interest to principal—an accretion which it is well settled is apportionable—is another indication of the intent of Congress not to tax a gain when received, but when earned.

(c) The Act specifically limits the income to be taxed to that accruing on and after March 1, 1913.

In the case of an individual, it is provided that for the year 1913 "said tax shall be computed on the net income accruing from March 1, to December 31, 1913" (clause D); and, in the case of a corporation, that for the same year "said tax shall be imposed upon its entire net income accrued within that portion of said year from March 1 to December 31, both dates inclusive, to be ascer-

tained by taking five-sixths of its entire net income for said calendar year" [clause G, subd. (e)].

(d) *It is significant that the Act makes a distinction between dividends and the income derived from dividends.*

A dissolution dividend distributing corporate capital, or a dividend declared from other than net earnings accruing since the adoption of the Sixteenth Amendment to the Federal Constitution, would not constitute taxable gains or profits, and in no case would it be necessary to include them in the taxpayer's annual return. Hence, in prescribing what an individual shall set forth in his annual return, the Act adds a proviso that persons liable to the normal tax only "shall not be required to make return of the *income derived from dividends* on the capital stock or from the *net earnings* of corporations, joint stock companies or associations, and insurance companies taxable upon their net income" as provided in the Act (Clause D). It thus recognizes that, even in the case of an individual subject to the surtax, he would not be required to make a return of dividends that did not constitute income.

Similarly, the Act defines "net income" as including not all corporate dividends, but "gains, profits and income derived from * * * dividends" (Clause B).

As already stated, the Treasury Decisions with

regard to dissolution dividends recognize the fact that all corporate dividends do not constitute taxable income.

That as between life tenants and remaindermen dissolution dividends constitute capital has repeatedly been held.

Gifford v. Thompson, 115 Mass., 478;
Brownell v. Anthony, 189 Mass., 442;
Second etc. Church v. Colegrove, 74 Conn., 79;
Curtis v. Osborn, 79 Conn., 555, 562;
Wheeler v. Perry, 18 N. H., 307;
Wilberding v. Miller (Ohio), 106 N. E., 665.

(e) *The Act recognizes that a stockholder is the owner of his pro rata share of the corporate surplus before it is distributed in the shape of dividends.*

Though the surplus may be distributed in a later year as a dividend, the benefit of the surplus accrues to the stockholder as soon as the surplus is earned. This benefit may be reaped by the stockholder through a sale of his stock at an advanced price, the advance being the result of the accumulated surplus; or in a proper case he may even go into a court of equity and compel the payment of a dividend. The Act recognizes that stockholders own the undistributed surplus of their corporation and taxes them thereon in certain cases. The Act provides:

“For the purpose of this additional tax the

taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed."

Clause A, subd. 2.

Similarly, the Federal income tax law of 1870 provided:

"That in estimating the gains, profits, and income of any person, there shall be included
 * * * the share of any person of the gains and profits, whether divided or not, of all companies or partnerships * * *."

16 Stat. L., 257, Sec. 7.

Substantially the same provision is contained in the Federal income tax law of 1864.

13 Stat. L., 281, Sec. 117.

Its validity was upheld in *Collector v. Hubbard*, 12 Wall., 1, 17.

If a corporate surplus, before it is declared as a dividend, is income of a stockholder in such sense as to be subject to the income tax, it follows that the surplus must have become income of the stockholder as soon as it was earned by the cor-

poration; and if it was earned by the corporation prior to the adoption of the Sixteenth Amendment, it is not taxable within the terms of the Act, nor could it constitutionally be taxed without apportionment (*post*, pp. 78-92).

(f) The Act requires an individual to pay an "additional tax" on dividends where his income exceeds a prescribed amount, thus implying that the tax is supplemental to another and prior tax. But the individual pays no normal tax on dividends, and the corporation pays no income tax on surplus earned by it prior to March 1, 1913. Hence, in the case of dividends from such surplus, to what would the "additional tax" be an addition?

While an individual subject only to the "normal tax" does not include in his return "income derived from dividends," nor pay a tax thereon, the case is otherwise where the individual is subject to the "additional tax." The term "additional tax" implies that the tax is a supplement to, or increase of, another and prior tax. It would be a contradiction in terms to say that any given income is subject to the additional tax, unless it is also subject to the normal tax. The evident intent of the statute is to avoid double taxation, except in the case of dividends paid to holding companies. The corporation paying the dividend is not subject to the additional tax; hence income derived from the dividend is subjected thereto, in

case the recipient is an individual with a net income in excess of \$20,000 for the taxable year. On the other hand, dividends received by individuals subject only to the normal tax are not taxable if received from corporations "taxable upon their net income," the theory being that the corporations have in such case paid the tax. But manifestly no income tax could be levied or imposed upon a corporation in respect of surplus earned by it prior to the adoption of the Sixteenth Amendment; nor has the Act attempted to levy or impose any such tax. As neither the corporation owning such surplus nor an individual receiving a dividend thereof can be required to pay the normal tax thereon, if it is sought to impose the "additional tax" on the dividend received by the individual, to what is the "additional tax" an addition? No normal tax is possible; therefore there can be no additional tax. This is but further inherent evidence of the fact that the statute did not attempt to impose a tax, additional or otherwise, on a corporate surplus earned prior to March 1, 1913.

(3) THAT DIVIDENDS FROM A SURPLUS ACCRUED PRIOR TO THE SIXTEENTH AMENDMENT ARE NOT TAXABLE UNDER THE ACT HAS SEVERAL TIMES BEEN DECIDED BY THE COURTS.

Two of the decisions were by the United States Circuit Court of Appeals for the Eighth Circuit.

In both the judgment of the lower court was affirmed.

One of the cases, *Lynch v. Turrish*, 236 Fed., 653, 656 (C. C. A.), was a suit to recover the surtax paid upon a liquidating dividend received in the year 1914 by Turrish from a lumber company. The lumber company had been organized in 1903, and all of its capital stock subscribed at par. Most of its capital stock had been invested in timber lands, and the remainder in other property incidental to the lumber business. On March 1, 1913, its assets were worth at least twice the par value of its capital stock. Turrish had acquired his stock prior to March 1, 1913, paying therefor at par. During the latter part of the year 1913 the lumber company sold its entire assets for a sum equal to twice the par value of its stock and declared a liquidating dividend of \$200 per share. One-half of the amount received by Turrish the Commissioner of Internal Revenue held subject to the surtax. In other words, the Commissioner taxed so much of the dividend as exceeded the cost of the stock, on the ground that this excess was profit. The Circuit Court of Appeals held that Turrish was entitled to recover this tax, and said (SANBORN, J.):

"It is true that a corporation holds the legal title of, and the right to manage, control, and convey, its property, and that a stockholder is without that title and right. But, after all, the corporation is nothing but the

hand or tool of the stockholders, in which they hold its property for their benefit. They are the equitable and beneficial owners of all its property, and it is the mere holder and manager of it for them. * * * Whether the value of the property of a corporation is increased by a gradual advance through a series of years of the value of the same real or personal property held throughout, or by undivided income, gains, or profits the actual value of its stock is immediately and proportionately increased, and the holders of that stock may at any time convey their respective beneficial interests in that enhanced value in those undivided profits and in all the other property of the corporation by sale, gift, or devise. *The Collector v. Hubbard*, 12 Wall., 1, 20 L. Ed., 272. The position that a stockholder in a corporation has no interest in the enhanced value of its property, or in its undivided income, gains, profits, or surplus, until a dividend thereof is declared, is untenable and may not prevail.

* * *

“All the value of the property of the corporation and all the value of the stock of the plaintiff, whether it was due to capital assets, or income, or gains, or profits, or all of these combined, had arisen and accrued and had become their property before March 1, 1913. Words in a statute ought not to be given a retrospective operation, unless they are so clear, strong, and imperative that no other meaning can be annexed to them, or unless the intention of the legislature cannot be otherwise satisfied.”

The other case, *Lynch v. Hornby*, 236 Fed., 661, 662 (C. C. A.), was similarly a suit to recover the surtax paid under protest on a dividend received by Hornby from the Cloquet Lumber Company. Hornby had acquired his stock long prior to March 1, 1913. The entire capital stock had been subscribed for at par in cash. By the increase in value of its timber lands and by its business operations, the Company on March 1, 1913, had become possessed of property worth four times the par value of its stock. In the year 1914 the Company declared a dividend of sixty-five per cent. and informed its stockholders that twenty-four per cent. was paid out of net earnings during the current period, and forty-one per cent. out of the surplus which had been earned prior to March 1, 1913, such surplus having arisen from the sale of property owned by it on the date last mentioned. On the dividend of current earnings, the plaintiff, of course, paid the tax without protest; and the court held that he was entitled to recover the tax on the dividend paid out of surplus earned prior to March 1, 1913, saying:

“As none of the property which the Cloquet Company or Hornby held on March 1, 1913, whether it was original capital or previously earned surplus, income, gains, or profits, was intended to be made or was made taxable as income by the Income Tax Law of 1913, the complaint stated facts sufficient to show that this \$17,794 [*i. e.*, the dividend out of such surplus] was not so taxable.”

Another case against the defendant's contention is *Union Pacific Coal Co. v. Skinner*, decided March 2, 1917, by the United States District Court for the District of Colorado and not reported.

Still another case is *Gulf Oil Company v. Lewellyn*, 242 Fed., 709, 717, decided by the United States District Court for the Western District of Pennsylvania after the decision of the lower court in the case at bar. The Oil Company was held entitled to recover a tax paid by it under the Act, on dividends received by it from its subsidiary corporations and paid by the latter out of surpluses accrued prior to January 1, 1913. The court reached the conclusion that

"The dividends in question in this suit were not subject to the tax imposed, because they were a distribution of surplus earnings arising through a period of years, and which had accrued to, and the equitable ownership thereof was vested in, the plaintiff prior to January 1, 1913, and such earnings were not intended by Congress to be subject to taxation."

This case was reversed by the Circuit Court of Appeals for the Third Circuit, 245 Fed., 1, and is now before this court on *certiorari*.

Also the District Court of the United States for the Southern District of New York has in the cases of *Towne v. Eisner*, 242 Fed., 702 (reversed by this court Jan. 7, 1918), and of *Peabody v. Eisner*, unreported, followed its decision in the case at bar.

(4) STATUTES IN PARI MATERIA AND DECISIONS THEREUNDER.

Statutes *in pari materia* are to be read and construed together as the development of a uniform and consistent legislative design, or else as the modification of the original design to adapt it to changing conditions.

"And it is said that the rule of construction by the aid of statutes *in pari materia* is especially applicable in the case of revenue laws, which, though made up of independent enactments, are regarded as one system, in which the construction of any separate act may be aided by an examination of other provisions which compose the system."

Black on Income Taxes (2nd Edition),
Sec. 218;

Citing *United States v. Collier*, 3 Blatchf.,
325; Fed. Cas., No. 14,833.

The rule is still applicable notwithstanding the earlier statute has been repealed.

King v. Loxdale, 1 Burr., (Eng.) 445;
Southern Railway Company v. McNeill,
155 Fed., 756.

In *United States v. Smith*, 1 Sawy., 277; Fed. Cas., No. 16,341, it was held that all the successive acts of Congress from 1861 to 1867, imposing income taxes, were *in pari materia* and were to be construed as one continuous enactment, "and," says Black in his work on Income Taxes, Sec. 218, "of course, this doctrine may be expanded

so as to include the acts of Congress of 1894, 1909 and 1913."

It becomes important, therefore, to ascertain what construction has been placed upon the provisions of the earlier Federal income tax laws as respects dividends. In this connection it will be noticed that the income by which the Federal excise tax of 1909 is measured includes dividends "received" during the year, while all the various Federal income tax laws refer to "income derived from" dividends; except the laws of 1916 and 1917, which specifically define the dividends that are taxable. There is good reason for this change of phraseology; for an excise tax might be measured by a standard upon which an income tax could not be constitutionally imposed (*post*, pp. 90-91).

That Congress did not intend to impose an income tax on dividends paid out of surplus accrued prior to the adoption of the Sixteenth Amendment is shown by the language of the Federal income tax act approved September 8, 1916. In view of the rulings of the Treasury Department, Congress deemed it necessary to add to the definition of net income a proviso explicitly stating that the term "dividends" as there used—

"shall be held to mean any distribution made or ordered to be made by a corporation * * * out of its earnings or profits *accrued since March first, 1913* * * *."

39 Stat. L., 757, Sec. 2 (a), 766, Sec. 10.

A similar but more elaborate provision is contained in the War Revenue Law of 1917. In the new law, after the phrase quoted above, is added the following:

“But nothing herein shall be construed as taxing any earnings or profits accrued prior to March 1, 1913, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March 1, 1913, has been made.”

(Sec. 31 added to Income Tax Act of Sept. 8, 1916, by Sec. 1211 of War Revenue Law of 1917.)

The defendant's argument *ab inconvenienti*, that Congress could not by the Act of 1913 have intended to put the Treasury Department to the inconvenience of ascertaining the sources from which dividends were paid, falls flat in the face of the provisions of the Acts of 1916 and 1917, provisions so specific that they cannot be construed away by Treasury decisions. Moreover, the inconvenience to the Treasury Department is more fancied than real, as the burden is on the taxpayer to prove that the dividend is not taxable.

Bailey v. R. Co., 106 U. S., 109, 116.

Indeed, the Bailey case is a complete answer to all of the defendant's contentions. It arose under the Federal income tax law of 1864 and

came before this court twice (22 Wall., 604, and 106 U. S., 109). In that case, during a period of fifteen years, from 1853 to 1868, the New York Central Railroad Company had expended from its earnings large amounts for additions and betterments and the acquisition of property. In the latter year it declared a scrip dividend of eighty per cent. on its capital stock, upon which an internal revenue tax of five per cent. was assessed, with an added penalty of \$1,000, under Sec. 122 of the Act of 1864, providing as follows:

“That any railroad, * * * company * * * that may have declared any dividend in scrip, or money due or payable to its stockholders, as part of the earnings, profits, income, or gains of such company, and all profits of such company carried to the account of any fund, or used for construction, shall be subject to and pay a duty of five per centum on the amount” thereof “*whenever the same shall be payable.*”

13 Stat. L., 284.

From this assessment, amounting to over \$1,000,000, an appeal was taken. As the scrip dividend represented earnings accrued during a period of fifteen years, of which only six years were covered by the income tax law, which first took effect in September, 1862, the Secretary of the Treasury remitted the tax on nine-fifteenths of the dividend and assessed the tax on the remainder, together with penalty and interest. Suit

was brought against the collector to recover the tax so exacted. On the first trial the lower court took the view that the transaction did not constitute a scrip dividend within the meaning of the statute, and, therefore, the assessment was held void. This judgment was reversed (22 Wall., 604). The second trial resulted in a judgment (affirmed by this court) decreeing the recovery of the tax.

In the court below the defendant sought to distinguish this important case upon the ground that the Act of 1864 was imposed on the corporation paying the dividend, while under the Act of 1913, the tax is upon the income of the recipient. This court, however, expressly made its decision independent of that question, saying upon the second writ of error (p. 116):

“There has been a difference of opinion upon the point whether the tax imposed by this section is upon the corporation, on account of its net profits, or upon the income of the stockholder or bondholder; although in the present case it is immaterial which of these alternatives is adopted.”

It is difficult to see how the case can be disposed of on a ground that this court has held to be immaterial.

The language of the Act of 1864 was more favorable to the Government's contention than is the language of the act of 1913. The former imposed the tax on any dividend payable “as part

of the earnings, profits income or gains of such company * * * *whenever the same shall be payable*"; the latter, upon the entire net income (namely, "gains, profits and income," less deductions and exemptions) "arising or accruing from all sources during the preceding calendar year." In one case the tax is upon the income when *payable*; in the other, when *arising or accruing*. Nevertheless, this court approved the charge of the Trial Judge, the substance of which (p. 111):

"upon the main point was, that while the certificates constituted a scrip dividend, which justified the assessment and constituted a complete *prima facie* defence to the action, nevertheless it was competent for the plaintiff to show what amount of the earnings of the Company, accruing from September 1, 1862 [the effective date of the act], to December 19, 1868, was represented by, and included in, the certificates; and that this amount alone being subject to the tax, the plaintiff was entitled to recover all which in excess thereof had been exacted and paid."

The court recognized that a dividend *prima facie* constituted taxable income, but that this presumption might be rebutted by proper proof, saying (p. 116):

"It was quite legitimate for the assessor to treat this [scrip dividend] as evidence of an amount of earnings which had never been taxed, and make the assessment accordingly. It was equally legitimate for the Secretary of

the Treasury, upon proof that the accumulation had been going on from the organization of the company, in 1853, to apportion the amount in equal proportions for each year, and to deduct nine-fifteenths thereof for the years which had elapsed before the taking effect of the act taxing incomes."

There the dividend had been declared and paid after, but earned before, the Act of 1864 became effective and the contention of the Treasury Department was substantially the same as here. This contention which was held to be unsound, was stated by the court to be as follows (p. 114):

"It is now urged in argument that, upon the express terms of this section, the certificates in question being a declaration of a dividend as part of the earnings, profits, income, or gains of the company, are taxable upon the amount thereof, without deduction; that the policy as well as the language of the act fixes the charge upon the declaration itself when made effectual as between the company and its stockholders, and, for the purposes of taxation, concludes both as to the amount subject to the tax; and that the rule is reasonable as furnishing an obvious standard and the only safe criterion for the assessment of the tax to prevent fraudulent evasions. And consequently that when such a dividend has once been declared, and ascertained to come within the description of the law as a subject of taxation, all the rest follows, and the amount declared is necessarily established as the amount to be taxed."

The court declined to adopt this standard because it was "the only safe criterion for the assessment of the tax to prevent fraudulent evasions," but was governed by the letter and spirit of the statute, stating that the tax was "an annual income tax," and that "its subject is the interest paid and profits earned by the Company for each year, and year by year," just as the Act of 1913 is an annual tax on net income arising or accruing "during the preceding calendar year."

In *Reynolds v. Williams*, 4 Biss., 108; Fed. Cas., No. 11,734, a railroad company had invested in Government bonds the sum of \$100,000 earned prior to July 2, 1863. In 1867 the railroad company consolidated with another company and placed these bonds in the hands of the plaintiff, as trustee for its stockholders, the company first mentioned ceasing to exist. In 1868 a five per cent. tax was assessed upon the bonds under the income tax law then in force, upon the ground that the bonds accrued to the stockholders as income at the time they were placed in the hands of the trustee. The statute under which the tax was imposed provided:

"That there shall be levied, collected, and paid annually upon the annual gains, profits, and income of every person * * * whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, * * * or from any other source whatever," a tax, &c. (14 Stat. L., 478).

The court held the tax improperly assessed, and answered in the negative the following question, which it said seemed to be the only question involved:

“Was said sum of \$100,000 of United States bonds either gains, profits or income acquired within the year 1867 in the sense in which these terms are used in the Act above cited?”

A further portion of the opinion is as follows:

“A railroad corporation is a mere ideal thing; and yet, in legal consideration, it is the owner of all the property which it controls—the road, the rolling stock, the capital stock, the accumulated funds. But, in my opinion, it being a merely artificial person, is only the legal owner of the property in trust for all the natural persons who are interested in it, including all stockholders, and all creditors.

“Now, it appears by the declaration that the bonds in question had been acquired by the railroad company as early as 1863. This accumulated fund remained on hand till the company ceased to be. For whose use did the company hold this fund? Not for the use of its creditors; for it does not appear to have owed any debts. So far as appears, the stockholders were the only natural persons in the world who had any interest in this fund; and it inevitably follows, that this artificial person, the railroad company, held it in trust for its stockholders. Hence, it is clear that, though the corporation was the legal owner of the bonds, yet the stockholders were the

equitable owners of them; or—to say the least—had an equitable interest in them. I must conclude, therefore, that the beneficiaries for whom the plaintiff held these bonds in 1867 had some interest in them before that year; and that consequently the bonds were not wholly an acquisition of 'gains, profits and income' accruing to them in that year."

There again the Government's contention was substantially the same as here. A tax was sought to be imposed on the bonds because the dividend of them had been declared in 1867, and they had then been placed in the hands of a trustee for the stockholders; but the court in construing the income tax law looked behind the legal fiction of distinct corporate entity, and recognized that the stockholders were the equitable owners of the corporate earnings and that these earnings had accrued to them before the enactment of the statute.

This case was subsequently reversed by this court in an unreported decision. The reversal did not affect the merits, but was based on the lower court's lack of jurisdiction. (See note appended to report of the case).

In *Merchants Insurance Company v. McCartney*, 1 Lowell, 447; Fed. Cas., No. 9,443, the same statutory provision was involved as in the preceding case. The plaintiff Insurance Company, as one of the stockholders in the Suffolk Bank, had paid under protest an income tax assessed under

the Act of 1864 upon the whole of an extra dividend declared by the Bank. Three-tenths of this dividend consisted of profits earned and laid aside by the Bank before the enactment of the income tax act there in question. The court held that the plaintiff was entitled to recover the tax paid on this three-tenths, and said (LOWELL, D. J.):

“As to the three-tenths, it seems to me to have been a division of capital, a return to the plaintiffs in money of a part of the property which was already in their ownership as capital stock when the first Act was passed. If the Suffolk Bank had been wholly wound up, and had returned to its stockholders the exact value of their shares in money, having made no profits since the passage of the original act, this sum of money could not be taxed as income, gains or profits, and so of a part. If the plaintiffs on receiving the money, chose to divide it among their own stockholders, *still it is not a dividend out of gains and profits, nor out of the surplus funds, because the surplus funds that are taxable are those which are or have been made out of profits since the passage of the act.* This view appears to have been acquiesced in by the Government, for they have neglected for some five years to enforce the opposite construction against the bank; and if this money was capital in the hands of the bank it was still capital when it reached the stockholders. The tax is assessed on the bank for convenience, but is intended to be, in effect, a tax on the shareholders; and if the latter be not assess-

able for the income tax, it cannot be levied on the corporation. *Railroad Company v. Jackson*, 7 Wall. (74 U. S.), 262."

In a later portion of the same opinion the learned judge stated that in drawing the foregoing conclusion he had not referred to the language of the statute, "because it seemed to me the result was the same *upon any fair meaning of the word income.*"

Gray v. Darlington, 15 Wall., 63, was an action to recover an income tax paid under protest. In 1865 the plaintiff had acquired certain Government bonds, which he sold in 1869 at an advance of \$20,000, and on this sum the tax was assessed under the Act of March 2, 1867, which provided that:

"There shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person, * * * whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, * * * *or from any other source whatever*, a tax of five per centum * * *. And the tax herein provided for shall be assessed, collected, and paid upon the gains, profits, and income for the year ending the thirty-first day of December next preceding the time for levying, collecting, and paying said tax."

14 Stat. L., 478.

The statute manifested an intention to tax

profits derived from the sale of property, for it contained a further provision that

"profits realized within the year from sales of real estate purchased within the year, or within two years previous to the year for which income is estimated,"

should be included in the taxable income, and also

"all other gains, profits, and income derived from any source whatever."

The Act of 1867 contained no restriction as to the time within which personal property must have been acquired in order that profits realized from its sale should be included as taxable income; and it will be noticed that the statute twice defined taxable income as gains, profits and income *"derived from any source whatever."* Nevertheless, this court held that profits from the sale of the bonds in question were not taxable and that the plaintiff was, therefore, entitled to recover. Stress was laid upon the fact that the tax was imposed upon the *annual* gains of a person and included only such income as might *"be realized from a business transaction begun and completed during the preceding year,"* with an exception as to profits from sale of real property within the two previous years. A portion of the opinion is as follows (p. 66):

"The mere fact that property has advanced in value between the date of its acquisition

and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.

"The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the statute."

Under the Corporate Excise Tax Act of 1909, where a lumber company had purchased timber lands years before, and the Government sought to include the increased value of the timber in the profits resulting from a sale of the manufactured lumber, the Circuit Court of Appeals said:

"It is clear, that by the term 'income,' Congress did not intend to include the proceeds of capital assets sold or converted during the year; nor can it be material whether such

proceeds are reinvested in other property or remain in the treasury of the company or are distributed to the stockholders; nor whether, in case of such distribution, they are called dividends or capital. The controlling question must be whether assets so converted were in fact at the beginning of the tax period, properly to be classed as capital assets. If they were of that character, they cannot be 'income' received during the latter period; they represent merely capital in a changed form."

Doyle v. Mitchell, 235 Fed., 686, 687.

(5) AS BETWEEN LIFE TENANT AND REMAINDERMAN, AN EXTRAORDINARY CASH DIVIDEND CONSTITUTES CAPITAL, IF PAID FROM SURPLUS ACCRUING PRIOR TO THE ESTABLISHMENT OF THE TRUST.

There is a wealth of authority on this subject and it is the well-settled rule of a majority of the States of the Union—a majority which in recent years seems to be increasing—that an extraordinary dividend of cash is to be apportioned between life tenant and remainderman in respect to the time of the accrual of the surplus out of which the dividend was paid.

Mr. Cook in his great work on Corporations refers to the foregoing statement of the law as constituting the "American Rule." He says (Vol. 2, 7th Edition, Sec. 554):

"This rule, inasmuch as it obtains in nearly every state in the Union, may well be called

the American rule. It proceeds upon the theory that the Court, in disposing of stock or property dividends, as between life tenant and remainderman, may properly inquire as to the time when the fund out of which the extraordinary dividend is to be paid was earned or accumulated, and also as to the method of accumulation. If it is found to have accrued or been earned before the life estate arose, it may be held to be principal, and, without reference to the time when it is declared or made payable, to belong to the *corpus* of the estate, and not to go to the life tenant. But when it is found that the fund, out of which the dividend is paid, accrued or was earned, not before but after the life estate arose, then it may be held that the dividend is income, and belongs to the tenant for life."

The same author expresses his opinion that where the extraordinary dividend represents "profits which were earned or accumulated before the life tenancy began . . . it is clear that in justice the remainderman should receive it. If, however, it was earned after the life tenancy began, it is clear that the life tenant should have it. If it was earned partly before and partly after the life tenancy began, then it is apparent that in justice some apportionment should be made if possible" (*id.*, Sec. 552).

See to same effect:

Morawetz on Corporations (2nd Edition), Sec. 467;

Thompson on Corporations (2nd Edition), Vol. 5, Sec. 5414.

The latter author thus states the rule (Sec. 5414):

"The courts now inquire into the actual nature and source of dividends for the purpose of determining their character. * * * The court in making the inquiry concerns itself with the substance of the transaction, and not the form in which the corporation has seen fit to clothe it."

The principle stated by the text writers is sustained by the following authorities, among many others:

- In re Stokes*, 240 Pa. St., 277 (1913);
- Earp's Appeal*, 28 Pa. St., 368;
- Matter of Osborne*, 209 N. Y., 450 (1913);
- Matter of Harteau*, 204 N. Y., 292;
- Thayer v. Burr*, 201 N. Y., 155;
- Ballantine v. Young*, 79 N. J. Eq., 70, 73;
- Lang v. Lang's Executor*, 57 N. J. Eq., 325;
- Van Doren v. Olden*, 19 N. J. Eq., 176;
- Bishop v. Bishop*, 81 Conn., 509;
- Second etc. Church v. Colegrove*, 74 Conn., 79;
- Holbrook v. Holbrook*, 74 N. H., 201;
- Peirce v. Burroughs*, 58 N. H., 302;
- Lord v. Brooks*, 52 N. H., 72;
- Müller v. Payne*, 150 Wis., 354 (1912);
- Soehnlein v. Soehnlein*, 146 Wis., 330, 340;

Gilkey v. Paine, 80 Me., 319;
Ex Parte Rutledge, 1 Harp., 65;
Cobb v. Fant, 36 S. C., 1;
Goodwin v. McGaughey, 108 Minn., 248,
 255;
 See Authorities cited *ante*, p. 44, and
post, Proposition VII.

In *Matter of Osborne*, 209 N. Y., 450, 474, decided in December, 1913, the court said:

"It is conceded that the capital of a corporation cannot be divided among the life beneficiaries. It is not alone the *capital of the corporation* that should be preserved, but the *capital of the trust fund* whether invested by the trustees in stocks of corporations at a premium, or acquired from the testator or maker of the trust. *The surplus of the corporation existing at the formation of the trust or when the stock is purchased represents a part of the capital of the estate as fully as does the capital of the corporation.* The division by corporations of their surplus accumulated through a long period of years in very large amounts is now comparatively common, when until within a very recent time such division of enormous amounts was seldom, if ever, made."

The court said that "the rights of the contending parties" should be determined "according to justice and equity," notwithstanding that in some cases the necessity for apportionment might cause difficulty, and continued (p. 477):

"In cases of extraordinary and unusual dividends declared in whole or in part from earnings actually accumulated prior to the creation of the trust or the purchase of the stock an adherence to the rule that dividends are deemed to have been earned as of the date of their declaration in many cases shocks the sense of justice."

On motion to amend the remittitur, in the same case, the court prescribed a simple method of making the necessary apportionment as follows (pp. 484-5):

"The proposition decided by us in this case is, that in all cases of extraordinary dividends, either of money or stock, sufficient of the dividend must be retained in the corpus of the trust to maintain that corpus unimpaired and the remainder thereof must be awarded to the life beneficiary. The method of accomplishing this result is not difficult. The intrinsic value of the trust investment is to be ascertained by dividing the capital and the surplus of the corporation existing at the time of the creation of the trust by the number of shares of the corporation then outstanding, which gives the value of each share, and that amount must be multiplied by the number of shares held in the trust. The value of the investment represented by the original shares after the dividend has been made is ascertained by exactly the same method. The difference between the two shows the impairment of the corpus of the trust. If

the dividend is of money the amount of that difference is to be retained by the trustee as capital, and the remainder paid to the life beneficiary. If the dividend is in stock the amount of impairment in money must be divided by the intrinsic value of a share of the new stock, and the quotient gives the number of shares to be retained to make the impairment good—the remaining shares going to the life beneficiary. Market value, good will and like considerations cannot be considered in apportioning a dividend.”

In *Lang v. Lang's Executor*, 57 N. J. Eq., 325, 329, the court said:

“We think that when a dividend is declared out of earnings, the reasonable presumption is that those earnings have been made uniformly, day by day, since the last similar dividend was declared, leaving parties in interest at liberty to show that the earnings were really made differently.”

Mr. Cook says (Vol. 2, 7th Edition, Sec. 555) that Massachusetts, Georgia, Rhode Island and Illinois have adopted another rule—a rule of convenience. In those States cash dividends are generally regarded as income and go to the life tenant, while stock dividends are regarded as capital and go to the remainderman. This is frequently referred to as the “Massachusetts Rule” or “Rule in Minot's Case.” It was announced

in the case of *Minot v. Paine*, 99 Mass., 101 (1868), as follows:

“A simple rule is, to regard cash dividends, however large, as income, and stock dividends, however made, as capital.”

Mr. Cook comments that while a simple rule, it “works great hardship and injustice in many cases” and “is not rigidly adhered to.”

Judge Thompson’s adverse criticism of the rule appears in Sec. 5410 of the fifth volume of the second edition of his work on Corporations.

“The Massachusetts doctrine seems to be a rule of mere convenience, and not of justice. It loses sight of the real question under consideration, what is *capital of the estate* disposed of by the will and not what is capital of the corporation.”

26 Am. L. Rev., 18.

As an evidence that the Massachusetts court cannot consistently follow the rule laid down by it, see the following cases:

Johnson v. Mfg. Co., 80 Mass., 274;
Heard v. Eldredge, 109 Mass., 258.

See also:

Leland v. Hayden, 102 Mass., 542, 550.

In *Heard v. Eldredge*, *supra*, a corporation declared a dividend of the proceeds of sale of property which had been taken by condemnation pro-

ceedings. Notwithstanding it was a cash dividend, the court held it to be capital.

In *Johnson v. Mfg. Co.*, *supra*, a regular periodical cash dividend declared after a life tenant's death from surplus earned during the life tenancy was held to belong to the life tenant's estate and not to the remaindermen.

The court said (p. 276):

"It is immaterial that the dividend sued for in this action was not declared until after her [the life tenant's] death; because it was for gain and profit earned and acquired during the year preceding the 31st day of May next before her death. It was income, therefore, which belonged to her, although preparation for its payment was not made until after her decease."

Moreover, in applying the rule of convenience to the disposition of dividends as between life tenant and remainderman, the courts are not hampered by the constitutional provisions which restrict the imposition of a Federal income tax. Except upon incomes, Congress has no power to levy direct taxes, unless apportioned among the several states according to population (*post*, pp. 78-90). Hence, if a part of the dividend is not income, but capital, no rule of convenience can justify the imposition of the tax on the whole of it. *Pollock v. Trust Co.*, 157 U. S., 429, 583-586. Where the amount of the dividend, whether regular or extraordinary, exceeds the entire surplus

earnings accrued since March 1, 1913, it is manifest that such excess is not income, but capital; and a rule of convenience is not needed, as it is perfectly simple to ascertain what are surplus earnings during such period.

This court has not passed upon the question of the ownership of an extraordinary cash dividend as between life tenant and remainderman, although, as we have seen, it has held that it would look into the earnings from which a dividend was declared in determining whether the dividend was subject to the Income Tax Act of 1864 (*Bailey v. R. Co.*, *supra*). In *Gibbons v. Mahon*, 136 U. S., 549, 559, the court held that a *stock* dividend was capital and belonged to the remainderman. In the case of a stock dividend, however, there is no distribution of surplus; it is merely a declaration by the corporation of its intention to capitalize surplus. If the entire surplus amounting to one hundred per cent. is declared as a stock dividend, each stockholder simply has two shares worth \$100 each, in place of one share worth \$200. The stockholder's proportionate interest in the corporation is not changed. He has the same proportionate voting right, the same proportionate interest in its property and earnings. These principles were stated in the court's opinion as follows:

"A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the sharehold-

ers. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same."

The decision turns largely upon the thought that the testatrix must have intended to leave to the corporate directors the determination of the question whether or not a distribution of earnings should be made. The court said (p. 569):

"To hold the plaintiff to be entitled to the whole of the new shares issued to the defendant would be to allow the plaintiff the exclusive benefit of earnings, the greater part of which had accrued and had been invested by the company as capital before her interest began, and would be contrary to all the authorities. To award to her a proportion of those shares, based upon an account of how much of those earnings actually accrued after the death of the testatrix, would be to substitute the estimate of the court for the discretion of the corporation, lawfully exercised through its directors, and would be open to the practical inconveniences already stated."

It by no means follows that this court would decline to apportion an extraordinary *cash* dividend as between remainderman and life tenant according as the dividend was declared from sur-

plus earned before or after the life tenancy began. As already stated, the court has pursued that course with regard to income taxes.

Bailey v. R. Co., 106 U. S., 109.

In accordance with this view, the lower Federal courts have held that they would go behind the mere declaration of an extraordinary cash dividend and ascertain from what source it was paid, in order to determine whether it belonged to the life tenant or remainderman.

Mercer v. Buchanan, 132 Fed., 501; 137 Fed., 1019 (C. C. A.).

Whatever view the courts may hold as to the intention of the maker of a trust to leave to the decision of corporate directors what shall be income and what capital, no such rule of convenience can be made applicable to the Federal income tax. But for the Sixteenth Amendment to the Constitution, this tax would be a direct tax and would be invalid, because not apportioned among the several States according to their population (*Pollock v. Trust Co.*, 158 U. S., 601). Income accruing prior to the adoption of the constitutional amendment cannot, therefore, be subjected to the tax (*post*, pp. 78-90). Hence the question now under consideration is a very different one from that ordinarily arising between life tenant and remainderman.

III.

The Act should be so construed as to avoid raising any question as to its constitutionality.

If the Act is given the construction for which the Government contends, it is unconstitutional (*post.* pp. 78-90, 96); but even if the invalidity of the Act, if so construed, were less plain, the constitutional question should be avoided by holding the dividends in question not subject to the tax. Only "income derived from dividends" should be taxed, not dividends of a pre-existing surplus which do not constitute income. Moreover we have the specific report of the Senate Committee in charge of the bill which afterwards became the statute in question, that it had been amended so as "to obviate the constitutional objection," which the Treasury Department's construction of the Act now raises (*post.* p. 83).

In *Harriman v. I. C. C.*, 211 U. S., 407, 422, this court held that the Interstate Commerce Act did not authorize the compulsory exaction of the testimony there sought, saying (Holmes, J.):

"If we felt more hesitation than we do, we still should feel bound to construe the statute not merely so as to sustain its constitutionality but so as to avoid a succession of constitutional doubts, so far as candor permits. *Knights Templar & Indemnity Co. v. Jarman*, 187 U. S., 197, 205."

In *United States v. Jin Fuey Moy*, 241 U. S., 394, 401, the court said (HOLMES, J.):

“A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional but also grave doubts upon that score. *United States v. Delaware & Hudson Co.*, 213 U. S., 366, 408.”

IV.

The Act is unconstitutional if construed as imposing a tax on dividends paid to one corporation by another out of a surplus that accrued prior to the Sixteenth Amendment.

The Federal Constitution requires direct taxes to be apportioned among the several States according to population (Art. I, Sec. 2, third clause, as amended by Fourteenth Amendment; and Art. I, Sec. 9, fourth clause); while an excise tax must “be uniform throughout the United States” (Art. I, Sec. 8). The language of the Sixteenth Amendment is as follows:

“The Congress shall have power to lay and collect taxes on *income*, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

Prior to the decision in *Pollock v. Trust Co.*, 157 U. S., 429, and 158 U. S., 601, income taxes had

generally been considered as indirect or excise taxes. (See historical resumé in that case and in *Brushaber v. R. Co.*, 240 U. S., 1.) In the *Pollock* case, however, it was settled that a tax on income derived from real or personal property was a direct tax and not an excise tax; and, therefore, in order to be valid, must be apportioned according to population.

All of the Railway Company's income is derived from real or personal property. All of its railroads and appurtenances are leased to the plaintiff, and its chief source of income is the rental derived therefrom. The surplus from which the dividends here in question were paid arose from this source and from the sale of its granted lands and other capital assets. Hence, the tax here sought to be recovered falls clearly within the decision in the *Pollock* case, holding such taxes to be direct.

Almost all capital results from the saving of income. As income is received and invested it becomes capital. The income of the Railway Company has been invested in additions and betterments to its railroad properties. Long prior to the adoption of the Sixteenth Amendment the surplus out of which these dividends were paid had become capital. The Sixteenth Amendment was not designed to permit the imposition of a tax on capital under the guise of an income tax. If all property that had once been income could now be made subject to an income tax, nearly all the capi-

tal of the country could be subjected to a direct tax without apportionment. This would practically abrogate the constitutional limitation requiring apportionment.

A limited degree of retroactivity may, perhaps, be given to an unapportioned income tax law enacted by Congress since the adoption of the Sixteenth Amendment, if the intention to make the law retroactive is explicitly stated; but there must be apportionment if the law seeks to tax income accruing from real or personal property prior to the amendment. For Congress was limited by the rule of apportionment until the amendment became effective, and a cardinal rule of construction requires a prospective operation to be given to constitutional amendments.

8 Cyc., 731 and 745, and cases cited.

See also:

Shreveport v. Cole, 129 U. S., 36, 43;

U. S. v. Burr, 159 U. S., 78;

U. S. v. American Sugar Refining Co.,
202 U. S., 563.

In *Reynolds v. M'Arthur*, 2 Pet., 417, 434, Chief Justice Marshall referred to a retrospective construction of a statute as "odious," and said:

"It is a principle which has always been held sacred in the United States, that laws by which human action is to be regulated look forwards, not backwards; and are never to be construed retrospectively, unless the lan-

guage of the act shall render such construction indispensable."

In *Brushaber v. R. Co.*, 240 U. S., 1, 18, the court said (White, C. J.):

"Indeed in the light of the history which we have given and of the decision in the *Pollock case* and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the [Sixteenth] Amendment was drawn *for the purpose of doing away for the future* with the principle upon which the *Pollock case* was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment."

The Act makes no provision for apportionment; and although it was enacted October 3, 1913, and imposed an income tax from the first day of the preceding March, its constitutionality was upheld. The court was, however, careful to limit its decision by saying (p. 20):

"But the date of the retroactivity did not extend beyond the time when the Amendment

was operative, and there can be no dispute that there was power by virtue of the Amendment during that period to levy the tax without apportionment, and so far as the limitations of the Constitution in other respects are concerned, the contention is not open. * * *” Citing *Stockdale v. Insurance Companies*, 20 Wall., 323, 331.

In *Tyee Realty Company v. Anderson*, 240 U. S., 115, 117, the merits of the contention there raised were not discussed by the court—

“because each and all of them were considered and adversely disposed of in *Brushaber v. Union Pacific Railroad*.”

Except the two just cited, no other case has yet been decided by this court in which the question of retroactivity was involved; and in both of those cases the retroactivity covered only a portion of a year and there had been no attempt to tax income accruing prior to the Sixteenth Amendment. Perhaps in those cases it would be more accurate to say that there was no retroactivity.

“For the year’s income is treated and considered as one entire thing, not as made up of several portions or items.”

Black on Income Taxes (2nd Edition), Sec. 212, and cases cited.

The Sixteenth Amendment authorizes the imposition, without apportionment, of a tax only on income, not on capital. An unapportioned tax

may now be measured by income accruing during a limited period prior to the passage of the tax law, provided the income has accrued subsequent to the Sixteenth Amendment; but the moment this law seeks to tax income that has accrued prior to the Amendment, it is a tax on capital, and not falling within the terms of the Amendment is repugnant to the Constitution. The report of the Senate Committee on the Tariff Bill (Senate Report No. 80, 63rd Congress, First Session) recognized the invalidity of an unapportioned tax on income accrued prior to the Sixteenth Amendment, by stating that the law had been "amended to obviate the constitutional objection to computing the tax on income accruing prior to the date on which the Amendment to the Federal Constitution authorizing the tax went into effect." Yet the Treasury officials so construe the Act as to raise the very objection that the amendment was intended to obviate.

In the case at bar, can the Treasury officials disregard the huge surplus that had accrued prior to the Sixteenth Amendment, and by so doing make that income which is not income within the true meaning of the term? A tax on capital cannot be made an income tax simply by denominating it as such. As was said by Mr. Justice Holmes in *G. H. & S. A. Ry. Co. v. Texas*, 210 U. S., 217, 227, where the question involved was whether or not a tax was a burden upon interstate commerce:

"Neither the state courts, nor the legisla-

tures, by giving the tax a particular name or by the use of some form of words, can take away our duty to consider its nature and effect."

Both the Treasury officials and the trial court have, however, held otherwise. The assessment and collection of the tax by the Treasury officials and the upholding of their action by the trial court necessarily embody the decision that the tax imposed does not violate the Constitution, and that the dividends in question are income within the meaning of the Sixteenth Amendment. As to the facts the trial court said (R., a19):

"The testimony of the plaintiff's accountants, together with its books" [the case went to trial upon the plaintiff's evidence alone], "would indicate that the claim of the plaintiff was well founded so that it may be assumed that the two extraordinary dividends of twenty per cent. each on the preferred and common stock of the Railway Company, paid in January, 1914, and the extraordinary dividends of \$514,000 likewise paid on the preferred and common stock in January, 1914, must have been paid wholly out of the surplus accruing prior to July 1, 1909, and that at least \$2,313,234.20 of the six per cent. dividend paid on the common stock in June, 1914, must have been paid out of the surplus accruing prior to July 1, 1909."

As we have seen, for income tax purposes the stockholders own the undistributed surplus of

their corporation (*ante*, pp. 36-37, 44). Hence, the question has been squarely determined by the trial court that the Constitution permits a tax to be levied, without apportionment, on a surplus that accrued long prior to the adoption of the Sixteenth Amendment. It may be—indeed it would seem—that the trial court erroneously assumed that the Government could “not tax undistributed surplus as income to the stockholders because they [sic] were income to the stockholder when paid and not before” (R., a21). Nevertheless, the result of the trial court’s decision is that an unconstitutional tax has been upheld over the plaintiff’s protests duly calling attention to its unconstitutionality.

The decision which is usually cited to sustain retroactive income taxation is *Stockdale v. Insurance Cos.*, 20 Wall., 323. That case involved one of the Civil War income taxes, and, as stated by the Chief Justice in the *Brushaber Case*, *supra*, it was the practice up to the time of the decision in the *Pollock Case*, to treat such taxes as excise taxes. As the tax considered in the *Stockdale Case* was then regarded as an excise tax, the court found no objection to its being given a few months’ retroactivity. The statute which the court was there considering did not impose a new tax *ab initio*, but continued an existing tax by declaring the construction of a prior statute. The continuation of the tax resulted in its imposition on the

income of the year in which the amendatory statute was enacted, though part of that year had elapsed when the latter statute was passed. Two of the justices, in a concurring opinion, held that no retroactivity was involved, because in their view, the duration of the tax was not limited prior to the enactment of the amendatory statute, and three of the justices dissented.

The case of *Stanton v. Baltic Mining Company*, 240 U. S., 103, cited by the defendant in error as determinative of the question presented in the case at bar, has no bearing upon it. There the constitutionality of the Act of 1913 was attacked on the ground that the tax it had imposed upon mining companies did not make adequate allowance for depreciation, and hence not only resulted in a tax on the profits derived from the operation of the mine, but also constituted a tax on the mine itself, and, therefore, a tax on capital. In other words, the Mining Company claimed that the sale of the products of the mine constituted to a large extent a conversion of capital assets. The court said (WHITE, C. J.), with regard to this contention (p. 113):

“It, moreover, rests upon the wholly fallacious assumption that looked at from the point of view of substance, a tax on the product of a mine is necessarily in its essence and nature in every case a direct tax on property because of its ownership, unless adequate allowance be made for the exhaustion of the ore body to result from working the

mine. We say wholly fallacious assumption because independently of the effect of the operation of the Sixteenth Amendment it was settled in *Stratton's Independence v. Howbert*, 231 U. S., 399, that such a tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations (pp. 413 *et seq.*).''

The *Stratton's Independence* case arose under the Corporate Excise Tax Act of 1909, and the question of inequality of operation of that statute as between mining and other corporations was thoroughly considered. It was held that mining ores was analogous to manufacturing, and that while the sale of a mine as a whole would be a conversion of capital assets, the extraction and sale of ore was not; that the mere fact that the mine would some day be exhausted no more made the extraction and sale of ore the conversion of capital assets than did the manufacture and sale of articles under a patent which would expire in a given number of years; or than did the earnings of the human hand and brain. There was no question presented in either of those cases of taxing income that had accrued prior to the Sixteenth Amendment, nor was the constitutionality of a law attempting to impose such a tax considered. Neither was it held, as claimed by the defendant in the lower court, that the Act authorized a tax on receipts from sales of capital assets. The

question of taxing capital assets was not decided, as it was specifically held that no tax had been imposed on capital; that the extraction and sale of ore did not constitute a sale of capital assets, but, on the contrary, an ordinary industrial business similar to a manufacturing enterprise.

Von Baumbach v. Land Co., 242 U. S., 503, 519, arose under the Act of 1909, and it was held that the Stratton's Independence and Baltic Mining Company cases were decisive of the questions there presented.

The bearing of *Edwards v. Keith*, 231 Fed., 110 (writ of certiorari denied, 243 U. S., 638), another case cited by the defendant, is equally remote. There it was held that the commissions of an insurance agent were taxable as a portion of the income for the year in which the commissions were received, where the policies had been written by him prior to the effective date of the Income Tax Act, but the premiums upon which the commissions became effective were paid thereafter. In the contract between the insurance company and the agent, it was expressly provided, however, that the commissions were not earned until the premiums were actually paid. If the policy holders died, or forfeited or surrendered their policies, or for any other reason failed to pay the premiums, then the agent was not entitled to the commissions. Under the circumstances, it was naturally held that the commissions accrued to the insurance agent when he became entitled

to them, namely, when the premiums were paid.
The court said:

"But the question seems to us a very simple one and one absolutely determined by the provision in all the contracts that 'commissions shall accrue only as the premiums are paid in cash.'

• • • • •
"It may be noted that, although fully earned by work already done, there is no certainty that the sum conditionally promised for an ensuing year will ever be paid or will accrue or come due; John Doe may die within the first year, or at its expiration may refuse to renew his policy, in which event the company is not obligated to pay its agent anything beyond the amount already paid him, the obligation to pay does not arise until John Doe actually pays his renewal premium in cash" (p. 112).

The question there was very different from that in the case at bar. Here the stock of the Railway Company had increased in value prior to 1909, owing to the existence of the large surplus that was distributed in January, 1914. The plaintiff not only had actual possession of the assets of the Railway Company, but as the holder of its entire stock became beneficially entitled to the surplus in question as it was earned; while the insurance agent had no claim, equitable or otherwise, to commissions until the premiums were paid.

His commissions were not only received but actually arose and accrued after the Act became effective. The one interest was vested, the other speculative and contingent. To perceive a resemblance between that case and the case at bar is but a failure to see differences.

Other authorities which hold that a tax may be imposed on income accruing prior to the enactment of the statute laying the tax are either decisions arising under State income tax laws, which are not restricted by the provisions of the Federal Constitution (Black on Income Taxes, 2nd Edition, Sec. 212), or they are decisions in regard to excise taxes. In the latter class of cases, the tax is not imposed *upon* income, but *measured by* income, and being an indirect tax, it is freed from Constitutional restrictions in regard to apportionment. An excise tax is an indirect tax measured by income, and may be imposed with or without apportionment regardless of the Sixteenth Amendment; while a tax on income derived from real or personal property prior to the adoption of the Sixteenth Amendment is a direct tax, and a direct tax cannot be imposed unless so apportioned.

Stratton's Independence v. Howbert, 231 U. S., 399;

Pollock v. Trust Co., 158 U. S., 601.

In *Stratton's Independence v. Howbert*, *supra*,

a case involving the construction of the Corporate Excise Tax Act of 1909, Mr. Justice Pitney said:

"As to what should be deemed 'income' within the meaning of Section 38, it of course need not be such an income as would have been taxable as such, for at that time (the Sixteenth Amendment not having been yet ratified), income was not taxable as such by Congress without apportionment according to population, and this tax was not so apportioned."

Again in *Flint v. Stone Tracy Company*, 220 U. S., 107, 162, the court, in answer to the argument that in certain cases the result of the Corporate Excise Tax Act of 1909 was to impose a tax on non-taxable securities, said that—

"This argument confuses the measure of the tax upon the privilege with direct taxation of the estate or thing taxed. In the *Pollock Case*, as we have seen, the tax was held unconstitutional, because it was in effect a direct tax. * * *"

On the other hand, in *Pollock v. Trust Co.*, 157 U. S., 429, 586, the court held the income tax law of 1894 unconstitutional upon the ground, among others, that it imposed a tax upon income derived from municipal securities, saying:

"It is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of

the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution."

The construction of the Act contended for by the Treasury Department would produce inequality and hardship and for this additional reason render the Act unconstitutional (*post*, pp. 92-98).

These constitutional questions were raised not only by the pleadings (R., a12), but during the course of the trial and at its conclusion by motion for a directed verdict (R., 135).

V.

Inequality and hardship result from the Treasury Department's construction of the law.

Suppose two men each invested \$100,000 in lands in the year 1905, and one forms a corporation for the purpose of holding his lands and the other does not. In 1908 the lands have in each case increased in value to the extent of fifty per cent. and are sold. In 1914, the corporation declares a dividend of its entire surplus amounting to \$50,000, and is subsequently dissolved and distributes its remaining assets. One investor will pay no income tax on the increased value of the investment, while the other will pay a large tax thereon. Yet the situation of each investor was the same, except that one did business through a corporate agency

and the other did not. Such a construction of the Act makes it in effect a tax on doing business as a corporation—not an income tax—while in fact it is an income tax, and not an excise tax.

Stratton's Independence v. Howbert, 231 U. S., 399, 414.

Again, suppose two men in December, 1912, invest \$400,000 each in bank stock at \$4,000 per share, and on March 2, 1913, one investor sells his 100 shares for its market value of \$4,100 per share. The bank on March 3, 1913, declares a dividend of its entire surplus earned prior to January 1, 1913, amounting to \$3,900 per share, payable March 15, 1913. On the date last mentioned the stock sells ex dividend at its book value of \$200 per share, and the second investor receives this \$200 per share through the sale of his stock. In both cases a profit of \$100 per share or a total profit of \$10,000 has been made. Yet in one case the investor will pay the income tax on \$10,000, while in the other he will pay the tax on the dividend of \$3,900 per share, or on \$390,000. The unfortunate investor who is thus discriminated against could not protect himself by treating the difference between the amount paid for the stock and that for which it sold as a deduction in computing his taxable income; for this would not, under the Treasury Department's ruling, be a loss sustained in trade (T. D., 2135).

Or, suppose in the year 1912 two investors pur-

chase stock in two banks respectively at \$4,000 per share, their book value, and each invests \$400,000 therein. One bank on March 2, 1913, declares a dividend of its entire surplus, viz., \$3,900 per share, and later, in December, 1913, dissolves, distributing its remaining assets of \$100 per share. The other bank dissolves in December, 1913, and as a dissolution dividend each shareholder receives \$4,000 per share. In the latter case the investor having made no profit pays no income tax. In the former case, although he has made no profit, he pays an income tax upon the fictitious gain of \$3,900 per share received as a dividend prior to dissolution, i. e., a tax on an alleged income of \$390,000.

The foregoing examples illustrate a few of the many inequalities that result from the construction of the Act contended for by the Treasury Department.

(1) THE SPIRIT OF THE ACT AS A TAX ON NET INCOME SHOULD PREVAIL.

The Treasury Department's contention is that a change in the form of capital, without increase in the taxpayer's aggregate wealth, constitutes taxable income. It results in taxing as income a mere conversion of capital. Even though the letter of the Act required such gross inequality and injustice as is contemplated by this contention—and we respectfully submit that it does not—the spirit

of the Act as a tax on net income arising or accruing during the preceding year should control.

"Of course, if it were demonstrable that to read the [Corporate Excise Tax] Act according to its letter would render it unconstitutional, or glaringly unequal, or palpably unjust, a reasonable ground would exist for construing it according to its spirit rather than its letter."

Stratton's Independence v. Howbert, 231 U. S., 399, 414.

(2) A CONSTRUCTION OF THE ACT PRODUCING INEQUALITY AND HARDSHIP SHOULD BE AVOIDED.

To impose an income tax on dividends when paid, and not when earned, produces inequality and hardship. This is well illustrated in the case at bar; for the plaintiff has been taxed on some \$20,000,000 of its subsidiary's surplus which the plaintiff has had possession of for years, merely because dividends were declared and constructively paid in January, 1914. If, however, the Railway Company had been dissolved and the distribution effected by means of a liquidating dividend, under the Treasury Decisions the question of tax would have depended on the cost of the stock.

In *Knowlton v. Moore*, 178 U. S., 41, 77, the present Chief Justice said with regard to the Federal Inheritance Tax Act of June 13, 1898 (30 Stat. L., 448):

"We are, therefore, bound to give heed to the rule, that where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute." (Citing cases.)

(3) MOREOVER, A CONSTRUCTION PRODUCING INEQUALITY AND HARDSHIP WOULD RENDER THE ACT UNCONSTITUTIONAL.

As was said by the court in *Society for Savings v. Coite*, 6 Wall., 594, 609:

"Common justice requires that taxation as far as possible should be equal."

While Congress may unquestionably make reasonable classifications for tax purposes, the classifications must not be arbitrary. Cooley on Taxation, 3rd Edition, Vol. I, page 4, says:

Taxes "differ from the enforced contributions, loans and benevolences of arbitrary and tyrannical periods, in that they are levied by authority of law, and by some rule of proportion which is intended to insure uniformity of contribution and a just apportionment of the burdens of government."

Gray on Limitations on Taxing Power, page 353, says that the limitations on the taxing power of Congress—

"are derived not from the words 'uniform throughout the United States,' but from the

general nature of all legislative power to tax, from the inherent elements of uniformity and equality which partly make up the concepts of taxation and taxes. The restrictions upon Congress in this regard arise from the very nature of legislative power as a power held in trust for the whole people."

In *Brushaber v. R. Co.*, 240 U. S., 1, 24, the court held that certain "numerous and minute, not to say in many respects hypercritical, contentions" did not render the Act repugnant to the Fifth Amendment, but added—

"That this doctrine would have no application in a case where although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion."

Mr. Justice Field, in his concurring opinion in the case of *Pollock v. Trust Co.*, 157 U. S., 429, 599, said:

"The inherent and fundamental nature and character of a tax is that of a contribution to the support of the Government levied upon the principal of equal and uniform apportionment among the persons taxed, and any

other exaction does not come within the legal definition of a tax.

"This inherent limitation upon the taxing power forbids the imposition of taxes which are unequal in their operation upon similar kinds of property, and necessarily strikes down the gross and arbitrary distinctions in the income law as passed by Congress."

Southern Railway Company v. Greene,
216 U. S., 400, 417;

County of San Mateo v. R. Co., 13 Fed.,
145, 150.

VI.

Unity of Southern Pacific System and consequent possession and control by the plaintiff of the funds from which the dividends in question were paid long prior to their declaration.

The plaintiff and its subsidiary corporations form a unified transportation system, and well illustrate the injustice that would result from a refusal to go behind the legal fiction of distinct corporate entity. The earnings of the various companies comprising the system are all kept together, the plaintiff acting as the banker of the system (R., 97-98). If one of the subsidiary companies has surplus earnings, these are deposited in the plaintiff's bank account. On the other hand, if the subsidiary needs money for additions and

betterments, or in order to make up a deficit from operation, the necessary expenditures are made by the plaintiff (R., 73-74, 97, 102). Proper entries on the books of the various corporations in interest are made (R., 35, 100-101), but as a practical matter the plaintiff makes no distinction between its own funds and those of its subsidiaries (R., 97-98). The plaintiff is also the lessee of the railroad properties of the Railway Company (R., 5, 36). The former is in possession of substantially all of the assets of the latter. There has been no particular necessity, therefore, for the Railway Company to dispose of its accumulated surplus by declaring a dividend. The plaintiff was actually in possession of the funds from which these dividends were declared long before their declaration; and being the owner of the entire capital stock of the Railway Company the plaintiff was neither richer nor poorer after the payment of the dividends than before. With regard to these two companies the court said in *U. S. v. Southern Pacific Co.*, 239 Fed., 998, 1000 (C. C. A.), a case in which it was held that they did not constitute a combination in restraint of trade within the meaning of the Sherman Anti-Trust Act:

“Except as to corporate title and bookkeeping, there were generally the aspects of a single enterprise.”

Hence, a refusal to go behind the fiction of distinct corporate entity works especial hardship in

the plaintiff's case, and emphasizes the technicality of the construction of the Act for which the Treasury Department contends. The courts will go behind this fiction in deciding whether or not an income tax should be imposed.

Collector v. Hubbard, 12 Wall., 1, 17
Bailey v. R. Co., 106 U. S., 109;
Lynch v. Turrish, 236 Fed., 653, 656;
Lynch v. Hornby, 236 Fed., 661.

In *Reynolds v. Williams*, 4 Biss., 108 (a case more fully discussed in an earlier portion of this brief, *ante*, pp. 59-61), the court held that a dividend declared in 1867 of property in which surplus earnings of prior years had been invested was not income for the year 1867 and that the stockholders were not taxable thereon under the income tax law of 1864, saying:

"A railroad corporation is a mere ideal thing; and yet, in legal consideration, it is the owner of all the property which it controls—the road, the rolling stock, the capital stock, the accumulated funds. But, in my opinion, it being a merely artificial person, is only the legal owner of the property in trust for all the natural persons who are interested in it, including all stockholders, and all creditors."

The same idea is stated by the court in *Lynch v. Turrish*, 236 Fed., 653, 656 (C. C. A.), as follows:

"In reality, as against its stockholders, a corporation has no and they have all the beneficial interest in its property."

This fiction is disregarded also in the application of the Sherman Anti-Trust Act.

Northern Securities Co. v. U. S., 193 U. S., 197. Also in many other cases.

Smith v. Moore, 199 Fed., 689 (C. C. A.);

Spencer v. Lowe, 198 Fed., 961 (C. C. A.);

Linn, &c., Co. v. U. S., 196 Fed., 593 (C. C. A.);

U. S. v. Milwaukee, etc., Co., 142 Fed., 247;

Cook on Corporations (7th Edition), Secs. 663 and 664;

Morawetz on Corporations (2nd Edition), Sec. 227.

In *Linn, etc., Co. v. U. S.*, 196 Fed., 593, 599 (C. C. A.), the court cites numerous authorities on this subject and quotes with approval Morawetz on Corporations (Sec. 227) as follows:

"The statement that a corporation is an artificial person or entity, apart from its members, is merely a description, in figurative language, of a corporation viewed as a collective body. A corporation is really an association of persons, and no judicial dictum or legislative enactment can alter this fact."

In *Spencer v. Lowe*, 198 Fed., 961 (C. C. A.), it was held that all of the stockholders of a corporation might legally divide the profits of the corporation among themselves by unanimous consent, without the formality of declaring a dividend.

VII.

Dividends paid from the sale of capital assets do not constitute income.

The surplus out of which the extraordinary dividends received by the plaintiff were declared had not only accrued prior to the Sixteenth Amendment, but \$3,401,448.48 of these dividends consisted of surplus arising from the sale of capital assets (R., 56).

As we have heretofore seen, this court has held that profits derived from the sale of personal property did not constitute taxable income within the meaning of the income tax law of 1867 (*ante*, pp. 63-66).

Likewise with regard to the Act, the Circuit Court of Appeals said in *Lynch v. Turrish*, 236 Fed., 653, 660:

"The enhanced value of the land or property of a corporation, or of the stock of a corporation, which slowly accrues through a series of years from the natural and gradual increase of the value of the timber land or other property which the corporation holds without trading, is more analogous to property, capital, or capital assets than to income, gains or profits. It is rather a growth, an increase of the property or capital assets, than income, gains or profits produced by the company."

On this subject, Foster on Income Tax, Sec. 46, says:

"An increase of capital when realized cannot justly be called profit or income. Examples are the increase in the value of real estate, or personal property, such as stocks, unless expressly provided in the statute. 'Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital.' "

Similarly it has been held that profits derived from the sale of capital assets did not constitute income within the meaning of the Corporate Excise Tax Act of 1909.

Gauley Mountain Coal Co. v. Hays, 230 Fed., 110 (C. C. A.);

Doyle v. Mitchell, 235 Fed., 686, 687 (C. C. A.);

Industrial Trust Co. v. Walsh, 222 Fed., 437, 443;

Baldwin Locomotive Works v. McCoach, 221 Fed., 59 (C. C. A.).

In *Miller v. Payne*, 150 Wis., 354, 378 (1912), a controversy between life tenant and remainderman under a testamentary trust, the court applied this rule, even though the corporation had earnings out of which the dividend might have been paid, saying:

"Any dividend derived from a mere enhancement of the value of assets representing capital from sources other than the accumulation of earnings belongs to the remainderman

and not to the life tenant. It represents corpus, not income."

In *Thayer v. Burr*, 201 N. Y., 155, it was held, as stated in the syllabus:

"Where a trust estate holds a corporate stock on which it has received bonds and scrip in the nature of a dividend representing in part earnings and in part an increase in the value of the investments of the company, the life tenant is entitled only to such portion of the bonds as represent earnings. The portion representing increased value of the corporate securities is a distribution of capital and belongs to the remainderman."

Some of the other authorities in support of this principal are:

Heard v. Eldredge, 109 Mass., 258;
Kalbach v. Clark, 133 Iowa, 215, 220;
Holbrook v. Holbrook, 74 N. H., 201.

Similarly it has been held that dividends paid from proceeds of sale of a portion of a company's original property or plant are capital and not income.

Mercer v. Buchanan, 137 Fed., 1019
 (C. C. A.);
Vinton's Appeal, 99 Pa. St., 434;
Holbrook v. Holbrook, 74 N. H., 201, 203;
Matter of Rogers, 161 N. Y., 108;
Eisner's Appeal, 175 Pa. St., 143;
Graham's Estate, 198 Pa. St., 216, 222.

Under the British Income Tax Act (16 & 17 Vict., c. 34) it is established that appreciations in

value of capital assets, even after the realization of profits by sale, do not constitute taxable income, except in cases of transactions by dealers or other persons who buy and sell for purposes of profits.

Tebrau (Johore) Rubber Syndicate v.

Farmer, 5 Tax Cas., 658;

Hudson's Bay Company v. Stevens, 5 Tax Cas., 424;

Assets Company v. Forbes, 3 Tax Cas., 542.

VIII.

Reply to the defendant's contentions in the lower court.

An answer to most of the defendant's contentions will be found in the prior part of this brief. To attempt to reply categorically to each of them would, therefore, involve needless repetition. Nor is it necessary further to discuss the proof that the dividends in controversy were paid from a surplus accruing prior to the adoption of the Sixteenth Amendment. For, unless the court holds that all the plaintiff's evidence on this subject is inadmissible, it is plain that at least a large part of these dividends was so paid; and if any part was so paid the judgment below should be reversed.

(1) In this connection, however, two contentions of the defendant will be noticed.

First.—The defendant argues that “for all we know, the lands and other properties of the Can-

tral Pacific Company may have risen in value to an extent sufficient to warrant the payment of the dividends in question." The evidence shows all profits resulting from the sale of property (Exhibits G and Q), but the defendant claims in effect that an appraisal of the Railway Company's line of road might show an increase in value of some \$20,000,000, in the period elapsing between the adoption of the Sixteenth Amendment and the declaration of these dividends about a year later; and that this increased value would constitute a profit from which the dividends could have been paid. The defendant, however, did not attempt to prove that any such increase in value actually existed. Even if such an enormous increase in value had taken place, and dividends could legally be paid therefrom, such dividends, when received by the plaintiff, would not have been taxable, because they would have been paid from capital assets and would constitute a distribution of capital and not of profits (*ante*. pp. 102-105). The statutes of Utah, the domicile of the Railway Company, forbid the payment of dividends, except out of "surplus profits arising from the business of the corporation"; and the directors are made criminally liable for violating this prohibition (Compiled Laws of Utah, Sec. 4411). They can ascertain what are surplus profits only from the corporate books, and the Interstate Commerce Commission's accounting regulations would not permit a railroad company to set up on its books, as a fund

from which dividends could be paid an estimated increase in value of corporate assets.

In *Eyster v. Centennial Board*, 94 U. S., 500, this court said that—

“The net receipts of a business are its profits.”

In *In re London, &c., Bank*, 72 L. T., 227, affirmed 2 Ch. 166, the court said that profits—

“are the excess of the current gains over the working expenses, as shown by revenue accounts, as distinguished from capital accounts.”

An increase in value of capital assets constitutes capital, not profits.

Industrial Trust Co. v. Walsh, 222 Fed., 437;

Baldwin Locomotive Works v. McCoach, 221 Fed., 59 (C. C. A.);

Miller v. Payne, 150 Wis., 354;

Cook on Corporations, 7th Edition, Sec. 544.

Furthermore, the resolutions declaring the two special dividends of 20 per cent., aggregating \$16,-935,100, specifically provided that they should be paid from surplus earned prior to January 1, 1913.

Second.—The defendant contends that the companies in which the Railway Company owned stock might have earned a surplus, and that these

surpluses, although undistributed, constituted profits from which the dividends in question could have been paid. (It will be noted that this is an admission by the defendant that a stockholder owns his *pro rata* share of the surplus of the corporation before its distribution as a dividend.) This contention is disposed of by what has been said with regard to the increase in value of corporate assets, namely, that such earnings could not properly have been taken up on the Railway Company's books (R., 126) and did not constitute surplus profits from which a dividend could lawfully have been declared and also by proof that none of the corporations in which the Railway Company owned stock had earned a net surplus during the period elapsing between January 1, 1913, and June 30, 1914, and that "the operations of none of those companies from the time of their incorporation up to and including the end of the year 1914, resulted in a net credit to surplus," except one which amounted to less than \$300,000 (R., 114)—manifestly a sum inadequate for the payment of \$20,000,000 of dividends.

(2) The defendant claims that it was incumbent on the plaintiff to allege and prove that "no net income arose and accrued to plaintiff, or was received by it, except that upon which it was lawfully taxed," and that the plaintiff has not done so. The complaint alleges that the plaintiff, pursuant to the terms of the Act, "filed with the defendant a return of its income for the six months

ending June 30, 1914''; and this return was offered in evidence, showing the gross, as well as the net, income of the plaintiff. The return was made under oath by one of the plaintiff's vice-presidents, and the affidavit of verification stated "that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the six months stated" (R., 141).

Further, the complaint alleges and the proof shows that the tax was imposed upon receipts which were not income, and therefore not taxable. The defendant stipulated that the tax was imposed upon an amount equal to the dividends in controversy; but, not content with this stipulation, the plaintiff proved that the tax which it seeks to recover was actually imposed on these dividends. This proof was as follows: On May 15, 1915, the Commissioner of Internal Revenue wrote the plaintiff, stating that an additional assessment was about to be made; and that the plaintiff had been informed as to the basis of the proposed additional assessment (R., 142). The information referred to by the Commissioner was received by the plaintiff from an Internal Revenue Examiner, and was, that the dividends in controversy were to be included in the plaintiff's taxable income, and an additional assessment made thereon (R., 6-9, Exhibit "2-H," 148). But, even if the plaintiff had other taxable income,

this would at best be an offset which it would be incumbent on the defendant to plead and prove. Nor could the tax on such additional income be offset until an assessment had been made by the Commissioner of Internal Revenue. The defendant had no power to make the assessment, nor would any such additional tax become due under the terms of the Act until ten days "notice and demand thereof" had been given to the plaintiff [clause G, subdivision (c)]. Not only is no such offset pleaded, but no such assessment has been made. The additional assessments made by the Commissioner are endorsed on the plaintiff's income tax return and are shown by the certified copy of this return which was offered in evidence (R., 139). Had there been additional income subject to tax, presumptively an assessment would have been made. Nor did the defendant, who was furnished every opportunity to examine the plaintiff's books and records (R., 59, 130-131), attempt to prove affirmatively that any such additional income existed.

Furthermore, this action is against the defendant as an individual, while the supposititious claim against the plaintiff for taxes, which the defendant urges has not been sufficiently negatived, is in favor of the Government. In this connection, the defendant's counsel introduced evidence showing the corporations in which the plaintiff owned stock, and that any undivided surpluses which these corporations may have had were not in-

cluded in the plaintiff's income tax return (R., 115-124). This was out-heroding Herod. The Treasury officials themselves do not contend that such undistributed profits are taxable. The receipt of this evidence was prejudicial error. The trial court denied the plaintiff's motion to strike out the evidence in question notwithstanding the following admission of defendant's counsel:

"The defendant does not consider this testimony *material to its case*, but is offering it merely to show the inconsistent position which the plaintiff has taken, and contends and will contend that without it there is a failure of proof, as far as the plaintiff is concerned" (R., 123).

There is, however, no inconsistency in the plaintiff's position. Its position is that not only are undistributed profits not taxable to a stockholder, but that distributed profits are also not taxable if paid from a surplus accruing prior to the Sixteenth Amendment. There is no question, however, that a stockholder can be taxed on his *pro rata* share in the undistributed surplus profits of his corporation, if Congress sees fit to provide therefor (*ante* pp. 36, 44).

In the Act, however, Congress has not so provided, except in the single case of an individual availing himself of a corporation and allowing its profits to accumulate in order to escape the sur-tax.

IX.

The plaintiff has taken the proper steps to recover the tax in controversy.

In view of the Treasury decisions on the subject, and in order to show the utmost good faith, a note was appended to the plaintiff's income tax return for the six months ending June 30, 1914, calling attention to the fact that dividends paid to the plaintiff out of surplus accumulated prior to January 1, 1913, had been excluded (R., 141). The tax was assessed and paid upon the basis of this return; but subsequently the Commissioner of Internal Revenue notified the plaintiff of his intention to make an additional assessment against it, imposing a tax on the dividends so excluded (R., 6-7). Thereupon, the plaintiff's counsel made an oral argument before the Commissioner of Internal Revenue and other officials of the Treasury Department, and also submitted a printed brief (Exhibit "2-C"). The brief submitted was substantially the same as this brief, and in the oral argument the Commissioner's attention was specifically called to the fact that the Railway Company's dividends had been paid from a surplus accruing prior to July 1, 1909. The Commissioner stated that the Department had already decided the questions involved, and considered these questions foreclosed, and that the additional assessment would be made accordingly.

On August 4, 1915, the defendant notified the

plaintiff that the additional assessment had been made, and that unless the tax was paid within ten days it would become his duty to collect the tax, together with five per cent. additional and interest at one per cent. per month until paid. In order to avoid threatened collection of the tax, with interest and penalties, the plaintiff paid the amount thereof, under protest, on August 13, 1915 (Exhibit "2-D").

Not only had an elaborate protest been submitted to the Commissioner of Internal Revenue against the assessment of the tax, but a full written protest was handed to the defendant at the time the tax was paid, and his attention was called to the fact that the tax was paid under the terms of this written protest (R., 4).

Although the points at issue had been fully presented to the Commissioner of Internal Revenue and an appeal to him was probably unnecessary in order to justify the institution of suit (Black on Income Taxes, 2nd Edition, Sec. 381; *Dodge v. Brady*, 240 U. S., 122), the plaintiff appealed to the Commissioner for a refund of the tax (Exhibit "2-E," R., 4). This appeal was denied October 15, 1915 (R., 4). Thereupon on October 22, 1915, the plaintiff instituted this suit.

The protests accompanying the plaintiff's return of net income and the payment of the tax, the brief submitted to the Commissioner of Internal Revenue, and the claim for refund of the tax are not set forth in the bill of exceptions, in

view of the stipulation that these instruments "were due and proper, and sufficiently raise and state all the grounds of objection upon which motions for a directed verdict were made by the plaintiff" (R., 4).

It is well settled that a suit may be brought against the Collector to recover an income tax illegally collected by him.

Black on Income Taxes (2nd Edition),
Sec. 377.

The payment of the tax was not voluntary, but made under duress.

Atchison, &c., Ry. Co. v. O'Connor, 223
U. S., 280;

Gaar, Scott & Co. v. Shannon, 223 U. S.,
468;

Cambria Steel Company v. M'Coach, 225
Fed., 278;

Black on Income Taxes (2nd Edition),
Sec. 380.

X.

The judgment of the lower court should be reversed.

The amendments made to the Act in 1916 and 1917 detract from the importance of the precedent to be established by the decision of this cause; but had there been no amendment, the Treasury Department would be occasioned no inconvenience by, and no evasion of the tax would result from,

the construction of the Act urged by the plaintiff. The rule should be established that all dividends received by one corporation from another are presumptively taxable, if declared and paid after the effective date of the Act, but that this presumption is *prima facie* and, in a proper case, may be rebutted, the burden of proof being on the corporation.

Bailey v. R. Co., 106 U. S., 109, 116.

The spirit and language of the Act and of statutes *in pari materia*, the rules of statutory construction—that of strict construction, that against possible conflict with the Constitution, against retroactive effect, against arbitrary and unequal taxation—and justice and fairness are opposed to the construction of the Act contended for by the Treasury Department.

Respectfully submitted,

GORDON M. BUCK,
Counsel for Plaintiff in Error.

Counsel for Plaintiff in Error.

247 U. S.

**SOUTHERN PACIFIC COMPANY & LOWE, UNITED
STATES COLLECTOR OF INTERNAL REVENUE
FOR THE SECOND DISTRICT OF NEW YORK.**

**ERROR TO THE DISTRICT COURT OF THE UNITED STATES
FOR THE SOUTHERN DISTRICT OF NEW YORK.**

No. 422. Argued March 4, 5, 6, 1913.—Decided June 3, 1913.

Accumulations that accrued to a corporation through surplus earnings or appreciation in property value, before the adoption of the Sixteenth Amendment (February, 1913), and the effective date (March, 1913), of the Income Tax Act of 1913 (Act October 3, 1913, c. 16, 38 Stat. 166), are to be regarded as its capital, not as its income for the purposes of that act.

Although, in general, the Income Tax Act of 1913, unlike that of June 30, 1894, treated corporate earnings as not accruing to the shareholders until the time when a dividend was paid (*Lynch v. Hornby*, post, 339), and although in ordinary cases the mere accumulation of adequate surplus does not entitle a shareholder to dividends until the directors, in their discretion, declare them, yet, where the shares of a corporation were all owned, and its property and funds possessed, and its operations and affairs completely dominated, by another corporation, so that the two were in substance but one, and where dividends from the one to the other were consummated, after the Act of 1913 became effective, by a mere paper transaction—formal vote of the directors of the first company and entries on the books of the two—and represented merely what the second company was entitled to have as shareholder before January 1, 1913, from a surplus theretofore accumulated, held, that such dividends were not taxable as income of the shareholding company within the true intent and meaning of the Income Tax Act of 1913.

236 Fed. Rep. 247, reversed.

This case is stated in the opinion.

Mr. Gordon M. Buck for plaintiff in error.

The Solicitor General, with whom Mr. Wm. C. Herron was on the brief, for defendant in error.

Mr. Robert R. Reed, by leave of court, filed a brief on behalf of the Investment Bankers' Association of America, as *amicus curiae*.

MR. JUSTICE PRIMER delivered the opinion of the court.

This case presents a question arising under the Federal Income Tax Act of October 3, 1913, c. 16, 38 Stat. 114, 166. Suit was brought by plaintiff in error against the Collector to recover taxes assessed against it and paid under protest. There were two causes of action, of which only the second went to trial, it having been stipulated that the trial of the other might be postponed until the final determination of this one. So far as it is presented to us, the suit is an effort to recover a tax imposed upon certain dividends upon stock, in form received by the plaintiff from another corporation in the early part of the year 1914, and alleged by the plaintiff to have been paid out of a surplus accumulated not only prior to the effective date of the act but prior to the adoption of the Sixteenth Amendment to the Constitution of the United States. The District Court directed a verdict and judgment in favor of the Collector, 233 Fed. Rep. 847, and the case comes here by direct writ of error under § 238, Judicial Code, because of the constitutional question. That our jurisdiction was properly invoked is settled by *Towne v. Biezer*, 245 U. S. 418, 425.

The case was submitted at the same time with several other cases arising under the same act and decided this day, viz., *Lynch v. Turrish*, ante, 221; *Lynch v. Hornaly*, post, 330, and *Peabody v. Biezer*, post, 247.

The material facts are as follows: Prior to January 1, 1913, and at all times material to the case, plaintiff, a

corporation organized under the laws of the State of Kentucky, owned all the capital stock of the Central Pacific Railway Company, a corporation of the State of Utah, including the stock registered in the names of the directors.¹ This situation existed continuously from the incorporation of the Railway Company in the year 1890. That company is the successor of the Central Pacific Railroad Company and acquired all of its properties, which constitute a part of a large system of railways owned or controlled by the Southern Pacific Company. The latter company, besides being sole stockholder, was in the actual physical possession of the railroads and all other assets of the Railway Company, and in charge of its operations, which were conducted in accordance with the terms of a lease made by the predecessor company to the Southern Pacific and assumed by the Railway Company, the effect of which was that the Southern Pacific should pay to the lessor company \$10,000 per annum for organization expenses, should operate the railroads, branches, and leased lines belonging to the lessor, and account annually for the net earnings, and if these exceeded 6 per cent. on the existing capital stock of the lessor the lessee should retain to itself one-half of the excess; advances by the lessee for account of the lessor were to bear lawful interest, and the lessee was to be entitled at any time and from time to time to refund to itself its advances and interest out of any net earnings which might be in its hand. The provisions of the lease were observed by both corporations for bookkeeping purposes. The Southern Pacific acted as cashier and banker for the entire system; the Central Pacific kept no bank account, its earnings being deposited with the bank account of the Southern Pacific; and if the

¹ There was another question, concerning a dividend paid by the Reward Oil Company, whose stock likewise was owned by the Southern Pacific Company, but the contention of plaintiff in over respecting this item has been abandoned.

Central Pacific needed money for additions and betterments or for making up a deficit of current earnings, the necessary funds were advanced by the Southern Pacific. As a result of these operations and of the conversion of certain capital assets of the Central Pacific Company, that company showed upon its books a large surplus accumulated prior to January 1, 1913, principally in the form of a debit against the Southern Pacific, which at the same time, as sole stockholder, was entitled to any and all dividends that might be declared, and being in control of the board of directors was able to and did control the dividend policy. The dividends in question were declared and paid during the first six months of the year 1914 out of this surplus of the Central Pacific accumulated prior to January 1, 1913; but the payment was only constructive, being carried into effect by bookkeeping entries which simply reduced the apparent surplus of the Central Pacific and reduced the apparent indebtedness of the Southern Pacific to the Central Pacific by precisely the amount of the dividends.

The question is whether the dividends received under these circumstances and in this manner by the Southern Pacific Company were taxable as income of that company under the Income Tax Act of 1913.¹

The act provides in § II, paragraph A, subdivision 1 (38 Stat. 106): "That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year" to every person residing in the United States a tax of 1 per centum per annum, with exceptions not now

¹ In addition, a question was made in the District Court as to a special dividend declared by the Central Pacific out of the proceeds of sale of certain land on Long Island, taken in satisfaction of a debt and sold in December, 1913. As to this, however, no argument is submitted by plaintiff in error, the facts are not clear, and we pass it without consideration.

material. By paragraph G (a) (p. 172), it is provided: "That the normal tax hereinbefore imposed upon individuals [1 per cent.] likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation . . . organized in the United States," with other provisions not now material.

It is provided in paragraph G (b), as to domestic corporations, that such net income shall be ascertained by deducting from the gross amount of the income of the corporation (1) ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals and the like; (2) losses sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any, and in the case of mines a certain allowance for depletion of ores and other natural deposits; (3) interest accrued and paid within the year upon indebtedness of the corporation, within prescribed limits; (4) national and state taxes paid. It will be observed that moneys received as dividends upon the stock of other corporations are not deducted, as they are in computing the income of individuals for the purpose of the normal tax under this act (p. 167), and as they were in computing the income of a corporation under the Excise Tax Act of August 5, 1909, c. 6, 36 Stat. 11, 113, § 33.

By paragraph G (c), the tax upon corporations is to be computed upon the entire net income accrued within each calendar year but for the year 1913 only upon the net income accrued from March 1 to December 31, to be ascertained by taking five-sixths of the entire net income for the calendar year.

The purpose to refrain from taxing income that accrued prior to March 1, 1913, and to exclude from con-

sideration in making the computation any income that accrued in a preceding calendar year, is made plain by the provision last referred to; indeed, the Sixteenth Amendment, under which for the first time Congress was authorized to tax income from property without apportioning the tax among the States according to population, received the approval of the requisite number of States only in February, 1913. *Pollock v. Farmers' Loan & Trust Co.*, 157 U. S. 429, 531; 158 U. S. 601, 637; *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1, 16.

We must reject in this case, as we have rejected in cases arising under the Corporation Excise Tax Act of 1909 (*Doyle v. Mitchell Brothers Co.*, ante, 179, and *Hays v. Gauley Mountain Coal Co.*, ante, 189) the broad contention submitted in behalf of the Government that all receipts—everything that comes in—are income within the proper definition of the term "gross income," and that the entire proceeds of a conversion of capital assets, in whatever form and under whatever circumstances accomplished, should be treated as gross income. Certainly the term "income" has no broader meaning in the 1913 Act than in that of 1909 (see *Stratton's Independence v. Howbert*, 231 U. S. 390, 416, 417), and for the present purpose we assume there is no difference in its meaning as used in the two acts. This being so, we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purpose of the act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer.

That the dividends in question were paid out of a surplus that accrued to the Central Pacific prior to January 1, 1913, is undisputed; and we deem it to be equally clear that this surplus accrued to the Southern Pacific Company prior to that date, in every substantial sense

pertinent to the present inquiry, and hence underwent nothing more than a change of form when the dividends were declared.

We do not rest this upon the view that for the purposes of the Act of 1913 stockholders in the ordinary case have the same interest in the accumulated earnings of the company before as after the declaration of dividends. The act is quite different in this respect from the Income Tax Act of June 30, 1864, c. 173, 13 Stat. 223, 281, 282, under which this court held, in *Collector v. Hubbard*, 12 Wall. 1, 16, that an individual was taxable upon his proportion of the earnings of the corporation although not declared as dividends. That decision was based upon the very special language of a clause of § 117 of the act (13 Stat. 282) that "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise." The Act of 1913 contains no similar language, but on the contrary deals with dividends as a particular item of income, leaving them free from the normal tax imposed upon individuals, subjecting them to the graduated surtaxes only when received as dividends (38 Stat. 167, paragraph B), and subjecting the interest of an individual shareholder in the undivided gains and profits of his corporation to these taxes only in case the company is formed or fraudulently availed of for the purpose of preventing the imposition of such tax by permitting gains and profits to accumulate instead of being divided or distributed.¹ Our view of the effect of this act upon

¹ "For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed

520

Opinion of the Court.

dividends received by the ordinary stockholder after it took effect but paid out of a surplus that accrued to the corporation before that event, is set forth in *Ignach v. Hornby*, post, 339.

We base our conclusion in the present case upon the view that it was the purpose and intent of Congress, while taxing "the entire net income arising or accruing from all sources" during each year commencing with the first day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before; and upon the fact that the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. And, besides, the funds represented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends. The fact that the books were kept in accordance with the provisions of the lease, so that these funds appeared upon

of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation . . . is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be *prima facie* evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business." (26 Stat. 160, 167.)

the accounts as an indebtedness of the lessee to the lessor, cannot be controlling, in view of the practical identity between lessor and lessee. Aside from the interests of creditors and the public—and there is nothing to suggest that the interests of either were concerned in the disposition of the surplus of the Central Pacific—the Southern Pacific was entitled to dispose of the matter as it saw fit. There is no question of there being a surplus to warrant the dividends at the time they were made, hence any speculation as to what might have happened in case of financial reverses that did not occur is beside the mark.

It is true that in ordinary cases the mere accumulation of an adequate surplus does not entitle a stockholder to dividends until the directors in their discretion declare them. *New York, Lake Erie & Western Railroad v. Nichols*, 110 U. S. 206, 306; *Gibbons v. Malen*, 136 U. S. 549, 558. And see *Humphreys v. McKinnell*, 140 U. S. 304, 312. But this is not the ordinary case. In fact the discretion of the directors was affirmatively exercised by declaring dividends out of the surplus that was accumulated prior to January 1, 1913; it does not appear that any other fair exercise of discretion was open; and the complete ownership and right of control of the Southern Pacific at all times material makes it a matter of indifference whether the vote was at one time or another. Under the circumstances, the entire matter of the declaration and payment of the dividends was a paper transaction to bring the books into accord with the acknowledged rights of the Southern Pacific; and so far as the dividends represented the surplus of the Central Pacific that accumulated prior to January 1, 1913, they were not taxable as income of the Southern Pacific within the true intent and meaning of the Act of 1913.

The case turns upon its very peculiar facts, and is distinguishable from others in which the question of the identity of a controlling stockholder with his corporation has been

339

Syllabus.

reversed. *Pullman Car Co. v. Missouri Pacific Ry. Co.*, 115 U. S. 587, 596; *Peterson v. Chicago, Rock Island & Pacific Ry. Co.*, 205 U. S. 364, 391.

Judgment reversed, and the cause remanded for further proceedings in conformity with this opinion.

MR. JUSTICE CLARKE dissents.